Petition

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IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1981

HILLSBORO NATIONAL BANK,

PETITIONER,

V.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

Robert A. Stuart, Esquire
Counsel for Petitioner
Brown, Hay & Stephens
700 First Nat'l Bank Bldg.
Springfield, Ill. 62701
Telephone: (217) 544-8491

IN THE SUPREME COURT OF THE UNITED STATES

October Term, 1981

HILLSBORO NATIONAL BANK,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

HILLSBORO NATIONAL BANK, Petitioner herein, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered herein on February 25, 1981. A Petition for Rehearing was denied on June 9, 1981.

QUESTION PRESENTED

Is a taxpayer required to include in income amounts deducted in an earlier year that are refunded to other persons in a later year, where the taxpayer did not receive the refund, direct the refund, know that it had been made, or receive any benefit as a result of the refund?

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OPINIONS BELOW

The opinion of the U. S. Court of Appeals for the Seventh Circuit is reported at 641 F. 2d 529

(1981) and is reproduced in the Appendix hereto, at page A-1. The opinion of the United States Tax Court is reported at 73 T.C. No. 5, and is reproduced in the Appendix, at page A-21.

JURISDICTION

The judgment of the U. S. Court of Appeals for the Seventh Circuit was entered on February 25, 1981, with one member of the three-judge panel dissenting. A timely Petition for Rehearing and Suggestion for Rehearing in Banc was denied on June 9, 1981, with two members dissenting. The jurisdiction of the Supreme Court is invoked under 28 U.S.C. 1245(1).

STATUTES INVOLVED

Section 111 of the Internal Revenue Code of 1954, as amended, 26 U.S.C. Sec. 111:

"(a) General Rule.--Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or

delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.

(b) Definitions.--For purposes of subsection (a)--

(1) Bad Debt.--The term 'bad debt' means a debt on account of the worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(2) Prior tax.--The term 'prior tax' means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(3) Delinquency amount.--The term 'delinquency amount' means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(4) Recovery exclusion.--The term 'recovery exclusion', with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Secretary or his delegate, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this subtitle (not including the accumulated earnings tax imposed by section 531 or the tax on personal holding companies imposed by section 541) or corresponding provisions of prior income tax laws (other than subchapter E of chapter 2 of the Internal Revenue Code of 1939, relating to World War II excess profits

tax), reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount under this section.

(c) Special rules for accumulated earnings tax and for personal holding company tax.--In applying subsections (a) and (b) for the purpose of determining the accumulated earnings tax under section 531 or the tax under section 541 (relating to personal holding companies)--

(1) A recovery exclusion allowed for purposes of this subtitle (other than section 531 or section 541) shall be allowed whether or not the bad debt, prior tax, or delinquency amount resulted in a reduction of the tax under section 531 or the tax under section 541 for the prior taxable year; and

(2) Where a bad debt, prior tax, or delinquency amount was not allowable as a deduction or credit for the prior taxable year for purposes of this subtitle other than of section 531 or section 541 but was allowable for the same taxable year under section 531 or section 541, then a recovery exclusion shall be allowable if such bad debt, prior tax, or delinquency amount did not result in a reduction of the tax under section 531 or the tax under section 541."

Section 164 of the Internal Revenue Code of 1954, as amended, 26 U.S.C. Sec. 164:

"(a) General Rule.--Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

(1) State and local, and foreign, real property taxes.

(2) State and local personal property taxes.

(3) State and local, and foreign, income, war profits, and excess profits taxes.

(4) State and local general sales taxes.

(5) State and local taxes on the sale of gasoline, diesel fuel, and other motor fuels.

In addition, there shall be allowed as a deduction State and local, and foreign, taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income).

. . .

(e) Taxes of shareholder paid by corporation.--Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation, then--

(1) The deduction allowed by subsection (a) shall be allowed to the corporation; and

(2) No deduction shall be allowed the shareholder for such tax."

STATEMENT OF THE CASE

The Commissioner of Internal Revenue has asserted herein that the Petitioner, HILLSBORO

NATIONAL BANK, must include in its taxable income for the year 1973 amounts representing Illinois capital stock tax refunds made by the treasurer of Montgomery County, Illinois, to shareholders of the Bank. The amounts, which were deducted when paid by the Bank in 1971, were not refunded to the Bank, nor was the Bank notified that the refunds were being made. Petitioner had no control over the amounts of the refunds or over the persons to whom refunds were made. Yet, the Commissioner seeks to include these amounts in the Bank's taxable income under the judicially-created "tax benefit rule", a position upheld by the Tax Court and the Court of Appeals below.

In 1972, the Hillsboro National Bank paid $31,424.55 in payment of the 1971 Illinois personal property tax which was imposed on all its shareholders based on their ownership of 4,500 shares of the issued and outstanding stock of the Bank. The entire amount of the 1971 Illinois personal property tax was paid out of the general

funds of the Bank. It was not paid from dividends declared before or after the payment, and the Bank did not withhold dividends from the shareholders as a result of the tax payment. The total amount paid was deducted on the 1972 Federal Corporate Income Tax Return of the Bank, as permitted by Section 164(e) of the Internal Revenue Code.

Effective January 1, 1971, the Illinois General Assembly amended the Illinois Constitution to prohibit the taxation of individuals on the value of their personal property. Litigation ensued. The Illinois Courts ruled that the amendment was unconstitutional under the United States Constitution. However, the Supreme Court of the United States ruled in Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356, 35 L. Ed. 2d 351, 93 S. Ct. 1001 (1973), rehearing denied, 411 U.S. 910 (1973) that the amendment to the Illinois Constitution was constitutional.

During 1973, following the decision of the United States Supreme Court, the treasurer of

Montgomery County, without consultation with the Hillsboro National Bank and based upon the advice of the Illinois Attorney General and the Illinois Department of Local Government Affairs, proceeded to issue refunds to 132 of the 149 shareholders of the Bank.

No refunds were made to the Bank, which had paid the taxes, or to those shareholders who the treasurer determined were not natural persons. The treasurer alone determined the amount of the refunds. The checks were payable solely to the individual shareholders. The Bank was not a joint payee. The checks were delivered to the shareholders. The Bank did not receive the checks, and did not know the amount of each shareholder's refund or the total amount refunded by the treasurer. In addition to the refunded taxes, the treasurer determined that interest earned on the tax payments while they were being held pending the litigation was payable to the individual shareholders.

The Hillsboro National Bank made no claim for the amounts refunded to its shareholders. No entries were made in the books or the records of the Bank to account for the payments from the treasurer to the individual shareholders.

The current earnings and profits of the Bank exceeded the personal property taxes paid by the Bank in 1972, and the payment of the taxes and the subsequent refund to selected shareholders did not alter the Bank's historic dividend policy.

REASONS FOR GRANTING WRIT

The expansion of the tax benefit rule endorsed by the Seventh Circuit herein was flatly rejected by the Ninth Circuit in Bliss Dairy, Inc. v. United States, 645 F. 2d 19 (9th Cir. 1981). The Ninth Circuit instead reaffirmed its decision in Commissioner v. South Lake Farms, Inc., 324 F. 2d 837 (9th Cir. 1963). The Seventh Circuit, in relying on its decision in First Trust and Sav-

ings Bank of Taylorville v. U.S., 614 F. 2d 1142 (7th Cir. 1980) and the Sixth Circuit's decision in Tennessee-Carolina Transportation, Inc. v. Commissioner, 582 F. 2d 378 (6th Cir. 1978), cert. denied, 440 U.S. 909, 59 L. Ed. 2d 457, 99 S. Ct. 1219 (1979), created a conflict over the scope of the tax benefit rule by determining that the rule requires a taxpayer to report, as taxable income, amounts it did not receive or control. In addition, one member of the three-judge panel of the Seventh Circuit wrote a strong dissent herein.

Further, the Seventh Circuit ignored this Court's decision in Commissioner v. First Security Bank of Utah, 405 U.S. 394, 31 L. Ed. 2d 318, 92 S. Ct. 1085 (1972), wherein this Court stated that a taxpayer was not required to report as taxable income amounts that it did not receive and that it was prohibited from receiving.

Because of the conflict among the circuits, and because the Seventh Circuit has ignored an

earlier decision of this Court, the Supreme Court's consideration of this case is both necessary and appropriate.

The interpretation urged by the government, and approved by the Seventh Circuit, is that benefits received by individual shareholders should be attributed to a corporate taxpayer through application of the tax benefit rule. However, according to the Ninth Circuit,

> "Nowhere in the Code do we find an intent that gains to the stockholders were to be attributed to the corporation, much less that they were to be treated as ordinary income to the corporation." Commissioner v. South Lake Farms, Inc. 324 F. 2d 837, 839, quoted with approval in Bliss Dairy, Inc. v. United States, 645 F. 2d 19, 20.

Although the disputes in South Lake Farms, Bliss Dairy and Tennessee-Carolina Transportation centered on the application of the tax benefit rule to corporate liquidations, a major issue in those cases was whether one taxpayer who had received the benefit of a deduction in an earlier year should be taxed in the current year when a

second taxpayer received a benefit that was inconsistent with the first taxpayer's earlier deduction. Similarly, in this case and in First Trust and Savings Bank of Taylorville v. United States, 614 F. 2d 1142 (7th Cir. 1980), the taxpayer-banks claimed proper deductions for taxes paid, and when refunds were later made, not to the banks but to their shareholders, the government asserted that the banks had received or recovered a benefit.

The confusion has been caused by a judicially-created exception to the requirement of actual recovery, which is now known as the "inconsistent event" principle. As stated by the Sixth Circuit in Tennessee-Carolina Transportation, Inc. v. Commissioner, 582 F. 2d 378 (6th Cir. 1978):

> "The (tax benefit) rule should apply whenever there is an actual recovery of a previously deducted amount or when there is some other event inconsistent with that prior deduction." (Emphasis in original) 582 F. 2d at 382.

The Court thereby substituted a form of constructive receipt for actual recovery, and in the process expanded the tax benefit rule.

The "inconsistent event" in Tennessee-Carolina Transportation, Inc. was the receipt by a taxpayer of value for property which had been expensed by the taxpayer in a prior year. The receipt of value was inconsistent with the earlier tax deduction. The tax benefit rule was applied to include the value of the property in the taxpayer's taxable income. However, the Ninth Circuit rejected a similar argument in both South Lake Farms and Bliss Dairy.

The "inconsistent event" theory was purportedly applied by the Seventh Circuit in First Trust and Savings Bank of Taylorville, where personal property taxes paid by the taxpayer were refunded to the shareholders. The facts therein were different from those in this case, because the refund checks there were payable to the bank and the shareholders jointly. The Seventh Circuit,

in each case, held the refunds were "inconsistent" with the bank's earlier deduction of those amounts.

The present case is the first in which a Court of Appeals has relied solely on the "inconsistent event" theory to apply the tax benefit rule. In both Tennessee-Carolina Transportation, Inc. and First Trust and Savings Bank of Taylorville, the courts found actual recovery. See, 582 F. 2d 378 at 382, and 614 F. 2d 1142 at 1146. In the former, the taxpayer's receipt of value for an item previously expensed represented actual recovery. In the latter, the receipt of refund checks by the bank as joint payee was actual recovery. However, in this case, the court had to rely exclusively on the inconsistent event theory.

The taxpayer-Bank's position herein is analogous to the taxpayer's position in Commissioner v. First Security Bank of Utah, 405 U.S. 394, 31 L. Ed. 2d 318, 92 S. Ct. 1085 (1972). The taxpayer here did not receive the tax refunds. It

was prohibited from receiving them because of the Montgomery County treasurer's decision to refund only to shareholders, and because of the Illinois Appellate Court's decision in Lincoln National Bank v. Cullerton, 18 Ill. App. 3d 953 (1st Dist. 1974).

Although the Seventh Circuit has characterized the refund of taxes as a distribution of dividends by the bank to its shareholders, its reasoning is flawed. A corporation may not pay dividends absent a declaration to that effect by its Board of Directors. There was no declaration of dividends here. Secondly, dividends, when declared, must be distributed on a pro rata basis to all shareholders of the same class. Here, the "dividend" was paid to only 132 of the bank's 149 shareholders, a clear violation of the pro-rata requirement.

As a result of the position taken by the Sixth and Seventh Circuits, taxpayers are at the mercy of future events that are beyond their control.

Decisions by unrelated parties--such as the treasurer of Montgomery County, Illinois--relative to disposition of deductible payments will have taxable consequences, regardless of the taxpayers' lack of involvement or control. At the same time, taxpayers in the Ninth Circuit can be sure that, absent receipt or control over disposition of amounts previously deducted, they are taxable only on income they receive.

The Commissioner's position and the reasoning of the Sixth and Seventh Circuits violates a basic concept upon which federal taxation is grounded, i.e., taxpayers should be taxed upon income received and, conversely, should not be taxed in the absence of receipt. While the constructive receipt and tax benefit rules are unquestionably a legitimate part of the system of federal taxation, designed to accomodate circumstances in which actual receipt of taxable income has not occurred, they are <u>not</u> substitutes or replacements for the general rule that a taxpayer

must receive a benefit in some form in order to be taxed. Receipt of a benefit, actual or constructive, sparks taxable consequences; receipt is absent in this case. The Commissioner has not demonstrated any benefit received by the taxpayer-Bank as a result of refunds to its shareholders.

A Supreme Court determination of the scope and coverage of the tax benefit rule is particularly appropriate in light of the judicial origin of the rule. The principle that a taxpayer must include in its income amounts received which were the subject of an earlier deduction was endorsed by this Court as early as 1931. Burnet v. Sanford & Brooks Co., 282 U.S. 359, 75 L. Ed. 383, 51 S. Ct. 150 (1931). It was necessary to reflect the limitations on the annual accounting principle, which is at the core of the federal taxation system. Thus, a deduction, properly taken on an annual tax return for Year 1, thereby reducing taxable income and tax paid for Year 1,

might later be recovered in Year 2, 3 or 4, as a result of a refund or otherwise. A taxpayer should include the amount recovered in the later year's income, to offset the earlier deduction. The net result, if viewed over the entire span of the taxpayer's existence, would be a consolidation of all gross income, offset by all proper deductions, over the entire span, not just on the year-to-year basis required by the Internal Revenue Code.

The federal courts continued to apply the rule after this Court's decision in Burnet v. Sanford & Brooks Co., 282 U.S. 359, 75 L. Ed. 383, 51 S. Ct. 150 (1931). In Nash v. Commissioner, 88 F. 2d 477 (7th Cir. 1937), it was applied to require a taxpayer to include in his 1932 income the amount of state income tax refunds received that year which had been paid and deducted on federal returns for the years 1926 to 1931. It was applied in Union Trust Co. v. Commissioner of Internal Revenue, 111 F. 2d 60 (7th Cir. 1940),

to require inclusion of inheritance tax refunds by a taxpayer who had earlier deducted the taxes paid. And in Alice Phelan Sullivan Corp. v. U.S., 381 F. 2d 399 (Ct. Cl. 1967), it was applied to a corporation to which property was returned by a charitable organization.

Congress recognized and impliedly endorsed the recovery rule by enacting Section 111 of the Internal Revenue Code. That section and the regulations thereunder limit inclusion of amounts recovered to the extent an earlier deduction produced a tax benefit. The cases and Section 111 of the Code have established a three-part test for applicability of the rule: 1) an amount previously deducted; 2) a tax benefit enjoyed as a result of the deduction; and 3) the recovery of the deducted amount in a later year.

Recent cases that have created the conflict between the Courts of Appeals, including this case, turn on a determination of whether a recovery has occurred in a particular situation.

As heretofore noted, this is the first instance in which a court has relied solely on the inconsistent event theory to hold that a taxpayer who received nothing--in cash or otherwise--should nevertheless pay additional taxes. This is not a case where the taxpayer itself or through a wholly-owned and controlled subsidiary recovered a previously-deducted item. It is not a case where the taxpayer was a joint payee of tax refund checks.

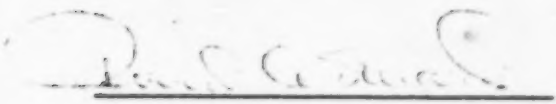
CONCLUSION

In summary, the Hillsboro National Bank seeks a determination that the reasoning of the Ninth Circuit represents the proper application of the tax benefit rule. The Sixth and Seventh Circuits have taken a position contrary to the Ninth Circuit's, and in so doing have held that a taxpayer can be taxed on amounts it did not receive and from which it received no benefit. The Bank

urges this Court to grant its Petition for Writ of Certiorari to review the judgment of the Seventh Circuit, and to ultimately reverse that judgment.

Respectfully submitted,

HILLSBORO NATIONAL BANK,
Petitioner



Robert A. Stuart
Counsel for Petitioner
Brown, Hay & Stephens
700 First Nat'l Bank Building
Springfield, Illinois 62701
Telephone: (217) 544-8491

Appendix

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

NO. 80-1480
HILLSBORO NATIONAL BANK,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

On Appeal from the United States Tax Court

ARGUED NOVEMBER 6, 1980--
DECIDED FEBRUARY 25, 1981

Before SWYGERT, Circuit Judge, WISDOM, Senior Circuit Judge,* and PELL, Circuit Judge.

WISDOM, Senior Circuit Judge. The issue on this appeal is whether the petitioner, Hillsboro National Bank, realized income under the tax benefit rule when state personal property taxes

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* Honorable John Minor Wisdom, Senior Circuit Judge for the United States Court of Appeals for the Fifth Circuit, sitting by designation.

it had paid on behalf of its stockholders and deducted from its income for federal income tax purposes in 1972 were refunded directly to the stockholders in 1973. We hold that the refunds were income to the Bank, and we affirm the ruling of the Tax Court.

This case concerns the remarkable recent history of the Illinois personal property tax. Before 1971, stockholders of any incorporated bank located within Illinois were subject to a personal property tax on the value of their shares. The banks were required to retain dividends sufficient to pay such taxes. Ill. Rev. Stat. ch. 120, Sec. 557, 558. Rather than retaining dividends, Illinois banks customarily paid these taxes out of general funds on their stockholders' behalf. They did not receive reimbursement from the stockholders. Conceptually these tax payments on the stockholders' behalf are a form of constructive dividend. Nevertheless, the Internal Revenue Code permits the banks to deduct such

payments from their corporate incomes. I.R.C. Sec. 164(e) (1976).

Effective January 1, 1971, Illinois amended its constitution to abolish the personal property tax as to individual taxpayers. Ill. Const. art. IX-A. In July 1971, the Illinois Supreme Court struck down this amendment as a violation of the equal protection clause of the fourteenth amendment and reinstated the tax on all taxpayers. Lake Shore Auto Parts Co. v. Korzen, 49 Ill. 2d 137, 273 N.E. 2d 592 (1971). The United States Supreme Court granted certiorari in the case. Faced with this unsettled situation, the Illinois legislature passed an interim measure directing that the taxes in dispute should be paid into an interest-bearing escrow account. If the abolition of the tax was ultimately upheld, the taxes thus paid would be refunded to the taxpayers. Ill. Rev. Stat. ch. 120, Sec. 676.01. Accordingly, on July 7, 1972, Hillsboro National Bank paid $26,110.32 in satisfaction of the 1971 personal

property tax owed by the Bank's individual stockholders on their Hillsboro shares. The bank deducted this amount on its 1972 federal income tax return under I.R.C. Sec. 164(e).

In February 1973 the United States Supreme Court reversed the Illinois court's decision and held that the abolition of the tax is constitutional. Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356, 93 S. Ct. 1001, 35 L. Ed. 2d 351 (1973). Accordingly, the County Treasurer of Montgomery County refunded the money the Bank had erroneously paid, plus interest. The Treasurer issued the refund checks directly to the Bank's stockholders, payable only to them. The Bank was neither consulted by the Treasurer nor informed of his action.

The Bank did not report any part of the 1973 refund as income. The Commissioner issued a notice of deficiency, alleging that the Bank should have reported the refund as income on its 1973 federal income tax return. The Bank peti-

tioned the U.S. Tax Court for relief. Deciding the case on stipulations and briefs, the Tax Court entered judgment for the Commissioner.

We conclude that this case is squarely controlled by our decision in First Trust & Savings Bank v. United States, 614 F. 2d 1142 (7th Cir. 1980). First Trust arose out of the same confusion over the Illinois personal property tax as this case. There, as here, the plaintiff bank paid the tax on behalf of its individual stockholders in 1972, and the state refunded the tax to the stockholders in 1973. We held that the tax benefit rule[1] required First Trust to re-

[1] The tax benefit rule provides that when a taxpayer decreases his tax liability by taking a deduction proper at the time, but a new event in a later year undercuts the factual basis for the deduction (as, for example, when the taxpayer recovers a previously deducted loss or expense), the taxpayer must report the proceeds of the later transaction as income in the later year—even if the later transaction would not have created taxable income if it had occurred in the earlier year. In effect, the taxpayer is making up for an unwarranted deduction taken in Year One by adding to his reported income in Year Two. See generally Block v. Comm'r, 39 B.T.A. 338 (1939), aff'd sub nom.; Union Trust Co. v.

port the refund as 1973 income, even though the bank itself did not pocket a penny of it.

First Trust and this case are identical on their facts, except for one detail.[2] In First Trust the state refund checks named the bank as joint payee with its stockholders, while here the refund checks were made payable to the stockholders alone. This difference had no effect on the parties' substantive entitlements to the funds, for the bank in First Trust was obligated to pay the refunds over to the stockholders, Lincoln

[1]Continued. Comm'r, 111 F. 2d 60 (7th Cir.), cert. denied, 311 U.S. 658 (1940); Alice Phelon Sullivan Corp. v. United States, 381 F. 2d 399, 402-03 (Ct. Cl. 1967); 1 J. Mertens, Law of Federal Income Taxa- tion Sec. 7.34, at 111 (rev. ed. 1974). Congress has indirectly acknowledged and sanctioned the rule. I.R.C. Sec. 111 (1976).

[2] There is one other difference between the cases. In First Trust the plaintiff bank paid the disputed federal income tax on the refunded state taxes and then sued in district court for a federal refund; in this case the Bank has not paid the federal tax because it appealed the Commission's notice of deficiency to the Tax Court. The parties concede that this procedural difference is entirely immaterial to the issues in this case.

National Bank v. Cullerton, 18 Ill. App. 3d 953, 958-59, 310 N.E. 2d 845, 849 (1974). Despite the purely formal character of the difference, the Bank contends that it distinguishes this case from First Trust. The tax benefit rule applied in First Trust, the Bank argues, because the taxpayer bank there, as joint payee, made an "actual recovery" of the previously deducted state tax.

This argument gives too narrow a reading to our construction of the tax benefit rule in First Trust. We held unambiguously that the rule applies in any case where there is either an actual recovery of a previously deducted amount or some other event inconsistent with that prior deduction. 614 F. 2d at 1145-46 & n.5; accord, Tennessee-Carolina Transportation, Inc. v. Commissioner, 582 F. 2d 378 (6th Cir. 1978), cert. denied, 440 U.S. 909 (1979); see Block v. Commissioner, 39 B.T.A. 338 (1939), aff'd sub nom. Union Trust Co. v. Commissioner, 11 F. 2d 60 (7th Cir.), cert. denied, 311 U.S. 658 (1940). Hence,

the taxpayer bank in First Trust was held liable on either of two alternative grounds: first, that the bank actually recovered the state refund as joint payee; and second, that the refund was a later event patently inconsistent with the deduction taken under Sec. 164(e). 614 F. 2d at 1146.

Clearly, the latter of these two grounds applies foursquare in this case. Illinois, by refunding the state property tax to the stockholders, transformed a tax payment deductible under Sec. 164(e) into a nondeductible cash dividend to the Bank's stockholders. Contrary to the Bank's contention, the tax benefit rule does not hinge upon whether the taxpayer "participates" in the later inconsistent event. The point is that the taxpayer has gained a windfall by taking a deduction that later developments show to have been unjustified.

AFFIRMED.

PELL, Circuit Judge, dissenting. Essentially, the majority members of the panel in this case, without any real analysis of the merits, feel themselves bound by this court's opinion in First Trust & Savings Bank v. United States, 614 F. 2d 1142 (7th Cir. 1980). Ordinarily, even though I regard First Trust as having been incorrectly decided, I would likewise feel bound by a prior applicable opinion of this court, particularly one as recent as First Trust. Because, however, I regard that case as distinguishable, I respectfully dissent.

Both in First Trust, 614 F. 2d at 1146, and in the majority opinion in the present case, there is a reference to the taxpayer bank having secured a "windfall". This just is not so. The taxpayer did, of course, take the deduction to which it was entitled by the revenue code.[1] While it got the benefit in the year the tax was

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[1] 26 U.S.C. Sec. 164(e) provides as follows:

> Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation, then—

paid this was nothing more than the ordinary situation in which a taxpayer is permitted a deduction for a state tax it has paid. That tax, however, was imposed not on the bank but was a tax on the individual shareholders of the bank. State statutes, such as the Illinois statute here involved,[2] made the bank liable for the tax on

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[1] Continued.

(1) the deduction allowed by subsection (a) shall be allowed to the corporation; and

(2) no deduction shall be allowed the shareholder for such tax.

[2] Illinois Revised Statutes, 1971, 120 Sec. 558, provides in pertinent part as follows:

> For the purpose of collecting such taxes, it shall be the duty of every such bank, or the managing officer or officers thereof, to retain so much of any dividend or dividends belonging to such stockholders as shall be necessary to pay any taxes levied upon their shares of stock, respectively, until it shall be made to appear to such bank or its officers that such taxes have been paid; and any officer of any such bank who shall pay over or authorize the paying over of any such dividend or dividends, or any portion thereof, contrary to the provisions of this section, shall thereby become liable for such tax; and if the said tax shall not be paid, the collector of taxes where said bank is located shall sell said share or shares to pay the same, like other personal property. And in case of sale the provision of law in regard to the transfer of stock when sold on execution, shall apply to such sale.

the shareholders' shares if the shareholders didn't pay the tax. Because of the obvious exposure resulting from some shareholders not getting around to paying a traditionally unpopular tax on intangible personal property, the banks, at least, from the early part of this century, have voluntarily paid all the tax owing by all of their shareholders. Yet, even though the tax would have been deductible if it had been paid directly by the shareholders whose obligation it was, no deduction was permitted by anyone until the enactment of the Revenue Act of 1921. As the Supreme Court pointed out in Wisconsin Gas & Electric Co. v. United States, 322 U.S. 526, 531 (1944):

> The origins of the present Sec. 23(d) in the Revenue Act of 1921 (now 26 U.S.C. Sec. 164(d)) disclose that its adoption was prompted by the plight of various banking corporations which paid and voluntarily absorbed the burden of certain local taxes imposed upon their shareholders but were not permitted to deduct those payments from gross income.

Wisconsin Gas in the marginal note supporting the above quotation refers to the Hearings before the Committee on Finance on H.R. 8245, U.S. Senate, 67th Cong., 1st Sess., 250-51. Turning to that legislative history we find the following:

> Dr. Adams. (Dr. T.S. Adams, Tax Adviser, Treasury Department) Now, Senator Smoot, reverting to your proposition, the Bankers' Association are asking that they be allowed to claim deduction for State and local property taxes which they pay. The banks pay these taxes for and on behalf of their stockholders. The taxes, you will remember, are on the stockholders. The bank voluntarily assumes it and pays it. The Banks now want to claim a deduction for it. They do it almost universally.
>
> Senator Smoot. If it were the stockholder it would be allowed, but as long as the bank takes it out, they do not allow it.
>
> Dr. Adams. They pay it voluntarily. A pays B's taxes voluntarily. The bank pays it voluntarily.
>
> (Informal discussion followed.)
>
> Dr. Adams. Banks may be given a deduction because, as a matter of strict legal theory, it is imposed on the stockholders and the stockholders do not take it. This is what worries me. The Revised Statutes provide the

> manner in which the banks shall take. The Federal statute provides this, that the States may tax the real estate of national banks as other real estate is taxed; and that, in addition, the value of the shares of the national banks may be included in the personal property of the shareholders. That is only taxed at the place where the bank is located. The consequence is that a habit has grown up of assessing the shareholders of the national banks and asking them to pay it.
>
> Senator Smoot. I have been a director in a bank out in Salt Lake City for over 20 years. They have paid that tax ever since I have owned a share of stock in the bank. I have never taken a single cent deduction in any way. I am president of a bank, too, and they pay every single cent of that tax. I know nothing about it. I do not take 1 cent of credit for deductions, and the banks are entitled to it. They pay it out.

This achieved an essentially fair situation, one which we like to think of as a hallmark of our system of voluntary taxation. In other words, the tax was paid and one, but only one, deduction was allowed. Unfairness did not rear its head until the Illinois personal property tax on individuals was abolished and a refund was

made. If this refund has been made to the bank which had voluntarily[3] paid the taxes, then under normal procedures of the tax benefit rule, the refund would have been taxable to the bank. The Appellate Court of Illinois, however, decreed otherwise as to the identity of the recipient of the refund, holding that it was the shareholder upon whom the tax had been imposed who was entitled to the refund. Lincoln National Bank v. Cullerton, 310 N.E. 2d 845 (1974). We now then have arrived at the situation presented by the present case. The bank receives not one penny of the refund and is not entitled to do so but it pays an income tax nevertheless. The shareholder who receives the refund must also include it in his taxable income. This is double taxation, purely and simply.

At the same hearing of the Committee on Finance quoted from above, an amendment of a dif-

[3] Under the circumstances of the voluntariness, it seems appropriate to italicize the word.

ferent part of the code was considered which throws light on the then position of the Treasury in an analogous situation:

> Dr. Adams. . . . The next change occurs in lines 24 and 25, at the bottom of page 76. "Nor shall such tax be included in the gross income of the obligee."
>
> That is a difficult point that has caused almost more trouble than anything in the law. The point is this: In the tax-free covenant bond the corporation pays the tax for the bondholder, or 2 percent of it. Now, while the debtor corporation is paying 2 percent for the bondholder and he is really paying that much tax for himself, still strict theory requires that the bondholder put that in his return as his income. We want to clear that up so that that particular interest shall not be included in the gross income of the obligee.
>
> Similarly, as far as I can ascertain, the IRS has not attempted to collect taxes from the shareholders for the payment by the banks of the local taxes; yet now, through a fortuitous circumstance of the tax refund, the endeavor is launched to

collect twice on the same sum, an endeavor which is now for the second time approved by this court.[4]

To put the matter in perspective, we can assume two parallel situations in substance but not in form with the resultant taxation dependent upon the form and not the substance.[5]

Bank A	Bank B
1972	
Shareholders pay their own Personal property tax. Shareholders who itemize deductions, take the deductions. The bank take no deduction. No income tax paid.	The bank pays the personal property tax of the shareholders. The bank takes the deduction. The shareholders take no deduction. No income tax paid.

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[4] Although the case of the shareholder taxpayers is not before this court, it was conceded during oral argument that the shareholders would have to include the refunds in taxable income.

[5] I am not unmindful that the difference between tax evasion and tax avoidance may be dependent upon form and, indeed, taxable consequences may often depend on the form of a transaction. In this case, however, even giving controlling significance to form over substance involves a situation where the bank taxpayer did not recover that from which it had a tax benefit.

Shareholders receive a refund. Bank receives no part of the refund. Shareholder includes amount of refund in taxable income. Bank has no taxable consequences.	Shareholders receive a refund. Bank receives no part of the refund. Shareholder includes amount of refund in taxable income. Bank also includes amount of refund in taxable income.

There remains only the matter of First Trust. I would be less than candid if I did not say that I think this panel should circulate an opinion to all of the active judges of the court pursuant to Circuit Rule 16(e), asking for approval of the overruling of First Trust. However, it is on its facts sufficiently distinguishable so that we do not need to overrule it. In First Trust, the refund checks were payable jointly to the bank and the shareholders. The bank there was in a position to assert its views as to the disposition of the checks. Here, the bank had no opportunity to exercise any control over the refunds; they went directly to the shareholders. In Lin-

coln National Bank, the Illinois court pointed out that the payment of the tax by the bank reduced pro tanto the assets of all of the shareholders. 310 N.E. 2d at 849. The payment of the income tax the following year in the present case will again achieve this effect. In addition, however, the shareholders' personal assets will also be reduced by the payment of income tax on the refund. If the bank has some say about the disposition of the refund checks, as it would if they were payable to the bank and the shareholders jointly, it is not inconceivable that the shareholders might be interested in declining what amounts to a double dip out of their assets.

The majority opinion in the present case denies validity to the bank's argument that an "actual recovery" was made in First Trust, and holds that this argument gives too narrow a reading to this court's construction of the tax benefit rule in First Trust. As I read the opinion of this court in that case it appears to me that

the court was unwilling to rest on the "windfall" aspect of the case, a situation which, as I have indicated, did not exist. Instead, the court went ahead to say:

> Moreover, even if an actual "recovery" by the Bank is viewed as essential to the application of the rule, we find such a recovery here. The Bank admittedly "received" the refunded taxes, in checks payable jointly to it and its stockholders. Although state law presumably precluded retention of the refund by the Bank, the relevant cases indicate that a "recovery" is not vitiated by a requirement that it ultimately be distributed by the taxpayer.

614 F. 2d at 1146. Here, of course, there was no recovery either in fact or in law. What there is here though is what to me is a distressing situation in a country whose founding was marked by

resistance to unfair taxation in which the unwarranted and unfair ingenuity of the tax collectors has now received judicial approval.

A true Copy:

Teste:

Clerk of the United States
Court of Appeals
for the Seventh Circuit

73 T.C. No. 5

UNITED STATES TAX COURT

HILLSBORO NATIONAL BANK, Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 8788-76. Filed October 11, 1979.

Petitioner paid and properly deducted, pursuant to sec. 164(e), I.R.C. 1954, state ad valorem taxes imposed upon its individual shareholders on their interests as shareholders. Later, and in a different taxable year, these state taxes were refunded directly to petitioner's individual shareholders. Held: petitioner had a sufficient "recovery" of the refunded taxes so as to render it taxable on the refunds pursuant to the tax benefit rule. Tennessee Carolina Transportation, Inc. v. Commissioner, 65 T.C. 440 (1975), affd. 582 F. 2d 378 (6th Cir. 1978).

John T. Bullington, for the petitioner.

William J. Falk, for the respondent.

OPINION

STERRETT, Judge:* Respondent determined a deficiency in petitioner's income taxes paid for its taxable year ended December 31, 1973 in the amount of $13,143.[1] After concessions the only issue left for our decision is whether or not petitioner had such a recovery of previously paid and deducted state taxes as to allow respondent to successfully invoke the tax benefit rule.

This case was submitted for decision under Rule 122, Tax Court Rules of Practice and Procedure. All the facts were, therefore, stipulated

*By Order of the Chief Judge dated June 20, 1979, this case was reassigned from Judge Bruce M. Forrester to Judge Samuel B. Sterrett for disposition.

[1]The amount of this claimed deficiency was based on respondent's determination that petitioner had understated its income by $27,383.16. The parties have stipulated that respondent was in error to the extent of $685.37. Thus the amount of understatement that respondent now claims is $26,697.79 which consists of $26,110.32 in taxes paid by petitioner on behalf of its individual shareholders, plus $587.47 in interest which accrued on, and was refunded with, these taxes.

and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioner Hillsboro National Bank (Hillsboro) is a national banking association. At the time it filed its petition herein Hillsboro maintained its principal place of business and principal office at Hillsboro, Illinois. Petitioner filed timely Federal corporate income tax returns for its taxable years ended December 31, 1972 and 1973 with the Internal Revenue Service Center, Kansas City, Missouri. A timely statutory notice of deficiency with respect to petitioner's 1973 taxable year was mailed to petitioner on August 5, 1976.

On July 7, 1972 petitioner paid $35,055.02 to the county collector of Montgomery County, Illinois. Of this amount $31,424.55 was paid by petitioner with respect to an Illinois state ad valorem personal property tax which, although paid by petitioner, was levied upon petitioner's

shareholders on their interests as shareholders.[2] Petitioner deducted this latter amount on its 1972 Federal corporate income tax return in accordance with section 164(e), I.R.C. 1954. The entire amount deducted resulted in a tax benefit to petitioner. Of the total taxes paid by petitioner on behalf of its shareholders, $26,110.32 was paid by petitioner with respect to

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[2]The taxes are levied upon petitioner's shareholders on their interest as shareholders by Ill. Ann. Stat., ch. 120, sec. 557, (Smith-Hurd), which read at all relevant times herein in pertinent part as follows:

Sec. 557. Listing and valuing stock of State and National banks

The stockholders of every kind of incorporated bank located within this State, whether such bank has been organized under the banking law of this State, or of the United States, shall be assessed and taxed upon the value of their shares of stock therein, in the taxing district where such bank or banking association is located and not elsewhere, whether such stockholders reside in such place or not. * * * Such shares shall be listed and assessed with regard to the ownership and value thereof as they existed on the first day of April annually * * *. (Sec. 557 was amended, in a way not material hereto, by P.A. 79-703, sec. 1, effective September 3, 1975.)

the value of its shares owned by natural persons, either singly or as joint tenants or tenants in common.

The entire amount of 1971 Illinois personal property taxes paid by petitioner on behalf of its shareholders was paid by petitioner out of its general funds and not from dividends declared before or after said payment. Dividends were not otherwise withheld from petitioner's shareholders as a result of petitioner's payment of their ad valorem tax liabilities. Petitioner has never received reimbursement from its individual shareholders in respect of its payment of their tax. Throughout 1972 and 1973 petitioner's current earnings and profits exceeded the amounts of 1971 Illinois personal property taxes paid by petitioner in 1972 on behalf of its individual stockholders.

Effective January 1, 1971 the Illinois constitution was amended to prohibit the taxation of individuals on the value of their personal prop-

erty. Ill. Const. of 1870, art, IX-A, effective January 1, 1971, Ill. State Const. of 1970, art. IX, section 5(b) (Smith-Hurd) (effective July 1, 1971). The constitutionality of this provision under the equal protection clause of the 14th Amendment of the United States Constitution was challenged in an action in the Cook County Circuit Court. That court held the amendment invalid as violative of the equal protection clause of the 14th Amendment to the United States Constitution. This holding was affirmed by the Illinois Supreme Court on July 9, 1971. Lake Shore Auto Parts Co. v. Korzen, 49 Ill. 2d 137, 273 N.E. 2d 592 (1971), rehearing denied August 24, 1971.

On April 3, 1972 the United States Supreme Court granted certiorari to the Illinois Supreme Court for the purpose of deciding the United States constitutional question involved in the Lake Shore Auto Parts Co. v. Korzen, supra, case. Lehnhausen v. Lake Shore Auto Parts Co.,

et al., 405 U.S. 1039 (1972). In the face of this impending United States Supreme Court decision involving the validity of the ad valorem tax, the Illinois legislature enacted section 676.01 Ill. Rev. Stat., ch. 120, effective July 27, 1972. This section provided in relevant part as follows:

> SEC. 676.01 Deposit of payments of personal property taxes extended in 1972--payment under protest presumed
>
> The county collector of each county shall deposit in a special interest-bearing escrow account an amount equal to all payments of ad valorem personal property taxes extended in 1972 against personal property owned by a natural person, or two or more natural persons as joint tenants or tenants in common, and received by him pending final disposition of Lake Shore Auto Parts v. Korzen, 49 Ill. 2d 137 (1971). All such payments shall be considered to have been made under protest. Each taxpayer for whom such tax payments are placed in escrow shall be eligible for automatic full repayment from the county collector if such personal property taxes are ultimately held to be invalid * * *. (Added by P.A. 77-2133, section 1.)

On February 22, 1973 the United States Supreme Court decided the case of Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356 (1973), re-

hearing denied 411 U.S. 910 (1973), in which it reversed the Illinois court and upheld the constitutionality, under the United States Constitution, of the Illinois constitutional amendment. On remand the Illinois Supreme Court confirmed that "(b)ank stock, like the shares of any other corporation, is exempt only when owned by a natural person or by two or more natural persons as joint tenants or tenants in common." Lake Shore Auto Parts Co. v. Korzen, 54 Ill. 2d 237, 296 N.E. 2d 342, 343 (1973).

During the year ended December 31, 1973, the county treasurer of Montgomery County, Illinois issued checks to 132 individual shareholders of the petitioner in amounts corresponding to the personal property tax deposited on their behalf by the petitioner. The amounts so paid to said individual shareholders were not transferred or repaid to petitioner. No payment was made by the county treasurer directly to petitioner. No tax refunds were made by the county treasurer to 17

other shareholders in petitioner, who were neither natural persons nor two or more natural persons owning shares as joint tenants or tenants in common.

The amounts paid to petitioner's individual shareholders totaled $26,697.79, i.e. $26,110.32 in refunded taxes, all of which had been paid and deducted by petitioner, plus $587.47 in interest. These payments were issued directly to the individual shareholders. No entries were made on the books and records of petitioner to account for these payments from the county treasurer to the individual shareholders of petitioner. The amounts so paid were not reported as income by petitioner on its Federal corporate income tax return for the year ended December 31, 1973.

The method of disposition of funds held in escrow by the county treasurer was based upon advice of the Illinois State's Attorney and the Illinois Department of Local Government Affairs.

The opinion of petitioner in this matter was neither solicited nor received by the county treasurer.

Until January 1, 1972, the petitioner kept its books and records on the cash receipts and disbursements method of accounting and computed its taxable income by the same method. At that time its assets first exceeded $25,000,000 and petitioner was required, under regulations promulgated by the Comptroller of Currency, to carry certain items on the accrual method of accounting on its financial books and records. In 1973, therefore, petitioner regularly kept its financial books and records on a combination of the cash receipts and disbursement method and the accrual method. Petitioner never sought respondent's permission to change its accounting method. In completing its 1973 Federal corporate income tax return, however, petitioner made adjustments on Schedule M-1 to reconcile its book income with its income for tax purposes—which

was still computed using the cash receipts and disbursement method.

To recapitulate briefly the relevant facts, during its taxable year ended December 31, 1972, petitioner paid ad valorem property tax levied by the State of Illinois on those of its shares of stock issued and outstanding on April 1, 1971. It received no reimbursement therefor from its shareholders and properly deducted the amounts paid on its 1972 taxable year income tax return under the provisions of section 164(e).[3] Petitioner paid these taxes on behalf of both its individual shareholders and "nonindividual" shareholders (e.g. corporations). The ad valorem

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[3]Sec. 164(e) Taxes of Shareholder Paid by Corporation.—Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation, then—

(1) the deduction allowed by subsection (a) shall be allowed to the corporation; and

(2) no deduction shall be allowed the shareholder for such tax.

tax on the shares of stock held by individual shareholders was subsequently determined to be invalid and the amounts petitioner had paid with respect to these shares refunded, along with accrued interest, during petitioner's taxable year ended December 31, 1973. The refunds were made not to the bank, however, but to the individual shareholders on whose behalf petitioner had paid the tax. The question for our decision herein is whether or not the refunds of amounts to petitioner's shareholders, which were originally paid and deducted by petitioner to its tax benefit, constitute a sufficient "recovery" so as to trigger income to petitioner under the tax benefit rule and section 111.[4]

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[4]SEC. 111. RECOVERY OF BAD DEBTS, PRIOR TAXES, AND DELINQUENCY AMOUNTS.

(a) General Rule.--Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.

Petitioner's argument is simple. It argues that, as it was at all times relevant hereto on a cash basis of accounting for tax purposes and as it never actually received any amount of the refunded taxes, it cannot be held to have had a "recovery" for purposes of the tax benefit rule. Respondent's argument is more complex. He argues, firstly, that petitioner has had a "recovery" because it not only deducted the taxes when paid, but also received a second benefit from payment of the taxes by way of "the discharge (in

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[4] Continued.

(b) Definitions.—For purposes of subsection (a)—

* * *

(4) Recovery Exclusion.—The term "recovery exclusion" * * * means the amount, determined in accordance with regulations prescribed by the Secretary or his delegate, of the deductions or credits allowed * * * which did not result in a reduction of the taxpayer's tax under this subtitle * * * reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount under this section.

See also sec. 1.111-1(a), Income Tax Regs.

1973) of petitioner's liability to its individual shareholders * * * to treat shareholders of the same class equally in the declaration and payment of dividends." Alternatively, respondent argues that "under Illinois law, the County Collector, having received funds in respect of a liability which was later held unconstitutional, held those funds upon a constructive trust for the rightful owner of the property, namely, the transferor, the petitioner." Under this line of argument respondent would have us find that petitioner had constructively received the refunded amounts and then paid these amounts out in discharge of its obligations to treat all shareholders of the same class equally with respect to the payment of dividends.

We agree with respondent that petitioner derived such a benefit from the refunds to its shareholders as to constitute a "recovery" for purposes of the tax benefit rule. We therefore hold for respondent.

The tax benefit rule is a judicially created doctrine embodying both transactional tax accounting and equitable aspects. The doctrine is intended to assure that income not taxed in year 1, because subject to a deduction, will be taxed in year 2 when the amount deducted is "recovered"--so long as the first year's deduction provided a "tax benefit" to the taxpayer in that taxable year. The doctrine contains three elements: (1) an amount previously deducted, (2) which deduction resulted in a tax benefit, and (3) which amount was recovered during the taxable year in issue. Putoma Corporation v. Commissioner, 66 T.C. 652, 664 (1976), affd. 601 F. 2d 734 (5th Cir. 1979).

Petitioner has conceded the first two elements of the doctrine. Thus, only the third element, i.e. "recovery", is here at issue. In the usual case a "recovery" occurs by way of either the actual receipt of funds or a release of liability resulting in an increase in the taxpayer's net

worth. Compare Citizens Acceptance Corporation v. United States, 462 F. 2d 751, 756-757 (10th Cir. 1972) (actual recovery), Alice Phelan Sullivan Corporation v. United States, 180 Ct. Cl. 659 (1967) (actual recovery) and Spitalny v. United States, 430 F. 2d 195, 198 (9th Cir. 1970) (actual recovery) with Putoma Corporation v. Commissioner, supra, Bear Manufacturing Company v. United States, 430 F. 2d 152, 154 (7th Cir 1970) and Mayfair Minerals, Inc. v. Commissioner, 56 T.C. 82, 87 (1971), affd. per curiam, 456 F. 2d 622 (5th Cir. 1972) (release from liabilities). On the other hand, it has been held that "for purposes of the tax benefit rule, a taxpayer may have recovered an item previously expensed although actually he has neither received nor become entitled to receive money or property." Tennessee Carolina Transportation, Inc. v. Commissioner, 65 T.C. 440, 447 (1975), affd. 582 F. 2d 378 (6th Cir. 1978). If the tax benefit rule is to attain its purpose of taxing the taxpayer's

actual income as that income is revealed over a course of taxable years, despite the inflexibility of the annual accounting principle, the rule must be applied practically. See Tennessee Carolina Transportation, Inc. v. Commissioner, supra 582 F. 2d at 382.

When Congress first enacted the predecessor of section 164(e), it was reacting realistically to a perceived disparity between the location of the burden of state taxes and the location of the benefit of the deduction engendered by the payment thereof. See e.g. Confidential Hearings on H. Rept. 8245 before the Senate Committee on Finance, 67th Cong., 1st Sess. 250, 251 (1921). In determining the tax effects of the transaction before us, it is incumbent upon us, likewise, to take a realistic view of the matter.

We believe that when the state constitutional amendment invalidating the ad valorem property tax on individuals was upheld, petitioner's "liability" thereunder was voided, and the refund

thereof was paid over to its shareholders, petitioner had a "recovery" sufficient to invoke the tax benefit rule. At that time the payment which petitioner had originally made for its shareholders' benefit, and permanently put beyond itself, was turned over to its shareholders. At that time the benefit which petitioner had intended to pay constructively to its shareholders was actually paid to them—this time without the benefit of the section 164(e) exception to dividend treatment. Together with the United States District Court for the Central District of Illinois we believe that, regardless of the location of the actual refund, "(f)or tax purposes at least, the bank * * * (had) as much entitlement to the refund as it had to take the deduction in the first place." First Trust and Savings Bank of Taylorville v. United States, _____ F. Supp. _____ (C.D. Ill. 1979) (79-2 U.S.T.C. par. 9446, 44 AFTR 2d 79-5253).

To hold otherwise would be to allow petitioner a deduction for a dividend distribution. Petitioner's payment of its shareholder's obligation to Illinois was not taxable as a dividend in 1972 only because it fell under the protection of section 164(e). When in 1973 that subsection was retroactively determined not to apply, and the taxes paid were refunded to these same shareholders, petitioner must be deemed to have received back its payments from the state and itself paid these amounts out to its shareholders. It is irrelevant for our purposes that this dividend was paid through the conduit of the state treasury.

Indeed the transfer of petitioner's erstwhile tax payment to its shareholders belies the assumption under which the original deduction was allowed, i.e. that petitioner was paying a state property tax. For Federal tax purposes at least we find it inescapable that, in order for petitioner's benefit to be paid to its shareholders

in a form other than a discharge of their obligation to pay taxes, petitioner must first be deemed to have recovered its payments. "In a sense * * * (this recovery) is fictional but certainly no more so than the initial fiction" that petitioner would be allowed to deduct its payment of its shareholders' obligation to Illinois without at the same time its shareholders having income. Tennessee Carolina Transportation, Inc. v. Commissioner, supra 582 F. 2d at 382.

Our holding in Tennessee Carolina Transportation, Inc. v. Commissioner, supra, is directly on point. In that case we found the tax benefit rule to apply to a section 332/334 (b)(2) liquidation where items previously expended by the liquidating subsidiary were ascribed a basis in the hands of the purchasing parent. We concluded that the tax benefit rule applied to give the liquidating corporation income even though the actual recovery in value with respect to the sub-

ject deductions accrued to its shareholders through the enhanced value of their stock. We held, in effect, that the recovery of this benefit by the subsidiary's shareholders was a sufficient recovery to tax their corporation. In this particular there is little to distinguish Tennessee Carolina Transportation, Inc. from the case presently before us.

This Court's application of tax benefit theory to a case involving a deduction by one taxpayer and a recovery to a second taxpayer was not new to our decision in Tennessee Carolina. In Corporation of America v. Commissioner, 4 T.C. 566 (1945), the taxpayer had deducted certain stamp taxes in 1930 which it had paid in that year under protest. As petitioner had net income this deduction would have normally resulted in a tax benefit. However, in 1930 the petitioner was part of a consolidated group and that group, as a whole, had a loss in excess of the petitioner's stamp tax deduction. In 1939, when the peti-

tioner was no longer filing as part of the consolidated group, it recovered the deduction. Despite the fact that two different taxpayers were involved, i.e. the consolidated group in 1930 and the petitioner in 1939, we applied the tax benefit rule to hold that the petitioner had no income in 1939 because the group had had no tax benefit in 1930. See also Ridge Realization Corp. v. Commissioner, 45 T.C. 508 (1966) where we applied tax benefit rule basis theory to protect one taxpayer from income upon its recovery of a second taxpayer's deduction. Thus, established principles of Federal taxation require that we find a recovery herein.

Our conclusion is in line with the recent decision of the United States District Court for the Central District of Illinois, First Trust and Savings Bank of Taylorville v. United States, supra at 79-2 U.S.T.C. par. 9446, 44 AFTR 2d 79-5253, where the court said:

> (I)t is admitted that the plaintiff banking corporation accepted the benefit of deducting the tax payments in 1972. Accordingly, it would be an anomalous to hold the bank free from taxation when the amount they paid and deducted is subsequently refunded. This is exactly the type of situation covered by the 'tax benefit rule' and defendant must prevail.

While the refund check in that case was made payable jointly to the shareholder and the bank, we do not believe this formalism to be dispositive.[5]

In addition, while not determinative, our holding that, for Federal tax purposes, petitioner had such an interest in the refunded taxes as to constitute a "recovery" for purposes of the tax benefit rule, also follows from local law.

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[5]We also note that petitioner does not appear to have objected to the refund to the shareholders without even its name being on the refund checks. We believe that petitioner's inaction was itself a means of obtaining the desired result. Petitioner, in effect, stood by and let this benefit flow to the natural objects of its bounty, i.e. its shareholders.

Where a determination of local law is relevant to a Federal tax case, the Federal courts are bound to give "proper regard" to the ruling of lower state courts. Commissioner v. Estate of Bosch, 387 U.S. 456, 465 (1967). The case of Lincoln National Bank v. Cullerton, 18 Ill. App. 3rd 953, 310 N.E. 2d 845 (1974), involved a class action suit by two national banking associations to obtain refunds of 1971 personal property taxes paid by them on their capital stock owned by individuals. The decision is one affecting substantial rights and was decided after an adversary hearing. In that case the Illinois Court of Appeals (1) impliedly found that the banks had an interest in the refunds, and (2) ordered refunds to be made directly to the individual shareholders for whom the funds had been originally paid out. Apparently, this mode of repayment was seized upon so as to avoid the need of channeling the money through the banks to the shareholders:

> (A) refund to the banks would be grossly inequitable. This would enable the banks to hold these refunds

> as part of their general assets which in turn would redound to the proportionate benefit of all shareholders, including those legal persons not individuals to whom the legislature never intended to make refunds. To sustain plaintiffs' contention but also to channel the refunds to the natural owners exclusively in accordance with the clear mandate of the constitutional referendum, as construed by the courts, the refunds would necessarily be made to the banks for the use and benefit of only the natural persons owning stock. This would present administrative and other problems which would best be solved by remitting the refunds directly to the individual owners entitled thereto. (Lincoln National Bank v. Cullerton, supra at 310 N.E. 2d 845, 849.)

While the court' s intendment on this exact point is not absolutely clear, we view this quote as recognizing that although the banks had an interest in the refund made to the individual shareholders, they would have been required to pay any amounts received to their shareholders as a dividend, and accordingly a refund directly to the shareholders was appropriate. This interest of the banks in the refunds was often palpably recognized by the state by making the checks out

to both the bank and the shareholder with the bank then automatically endorsing the check over to its shareholders. That this formalism was not followed in the case before us is irrelevant to the actual existence of the petitioner's interest in, and hence "recovery" of, the refunded taxes.

Different considerations apply to that part of the refunded amounts representing interest on the ad valorem taxes paid by petitioner, i.e. the $587.47. Petitioner never deducted this amount. The tax benefit rule and section 111 cannot, therefore, apply. Petitioner was not in receipt of income with respect to the payment of this amount to its shareholders.

Decision will be entered under Rule 155.

Opinion by Judge Wisdom

Judge Pell dissenting

UNITED STATES COURT OF APPEALS

For the Seventh Circuit

Chicago, Illinois 60604 6

February 25, 1981

Before

Hon. LUTHER M. SWYGERT, Circuit Judge
Hon. JOHN MINOR WISDOM, Senior Circuit Judge*
Hon. WILBUR F. PELL, JR., Circuit Judge

HILLSBORO NATIONAL BANK, a national banking association, Petitioner-Appellant,	)	Appeal from the United States Tax Court
No. 80-1480 v.	)	
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee.	)	

This cause was heard on the record from the United States Tax Court and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the judgment of the said Tax Court in this cause appealed from be, and the same is hereby, AFFIRMED, with costs, in accordance with the opinion of this Court filed this day.

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*The Honorable John Minor Wisdom, Senior Circuit Judge for the United States Court of Appeals for the Fifth Circuit, sitting by designation.

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

June 9, 1981

Before
Hon. LUTHER M. SWYGERT, Circuit Judge
Hon. JOHN MINOR WISDOM, Senior Circuit Judge*
Hon. WILBUR F. PELL, JR., Circuit Judge

HILLSBORO NATIONAL BANK,	)
	)
Petitioner-Appellant,	)
	)
No. 80-1480 v.	)
	)
COMMISSIONER OF INTERNAL REVENUE,	)
	)
Respondent-Appellee.	)

On Petition for Rehearing

On consideration of the petition for rehearing and suggestion for rehearing en banc filed in the above-entitled cause, a vote of the active members of the court was requested, and a majority of the active members of the court have voted to deny a rehearing en banc. A majority of the judges on the original panel have voted to deny the petition for rehearing. Accordingly,

IT IS ORDERED that the aforesaid petition for rehearing be, and the same is hereby, DENIED.

Circuit Judges Pell and Bauer voted to grant the petition for rehearing en banc.

*Senior Circuit Judge John Minor Wisdom of the United States Court of Appeals for the Fifth Circuit is sitting by designation.

CERTIFICATE OF SERVICE

The undersigned, Robert A. Stuart, Counsel for Petitioner, HILLSBORO NATIONAL BANK, hereby certifies that he has served three (3) copies of the foregoing Petition for Writ of Certiorari upon each party required to be served pursuant to applicable Supreme Court Rules, to wit: Solicitor General, Department of Justice, Washington, D.C. 20530; and Commissioner of Internal Revenue, IRS Building, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. Service was accomplished by depositing said copies, with postage fully prepaid, in a U.S. Post Office Mail Box in Springfield, Illinois, on the 4th day of September, A.D. 1981.

Robert A. Stuart

Opposition

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CLERK

No. 81-485

In the Supreme Court of the United States

OCTOBER TERM, 1981

HILLSBORO NATIONAL BANK, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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In the Supreme Court of the United States

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COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

The question presented in this federal income tax case is whether petitioner realized income under the tax benefit rule when certain taxes it had paid on behalf of its individual stockholders and claimed as a deduction for 1972 were refunded directly to those stockholders in 1973.

The pertinent facts are undisputed and may be summarized as follows: Petitioner is a national banking association with its principal place of business in Hillsboro, Illinois (Pet. App. A-23). Prior to 1971, the stockholders of incorporated banks within Illinois were subject to a personal property tax on the value of their shares. Ill. Ann. Stat. ch. 120, § 557 (Smith-

Hurd 1970). The banks were required to retain dividends sufficient to pay the taxes. Ill. Ann. Stat. ch. 120, § 558 (Smith-Hurd 1970). Rather than retaining dividends, Illinois banks customarily paid these taxes on behalf of their stockholders (Pet. App. A-2).

In 1970, Illinois amended its constitution, effective January 1, 1971, to prohibit ad valorem taxation on personal property owned by individuals. In July, 1971, however, the Illinois Supreme Court held the amendment to be invalid on the ground that it violated the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution. *Lake Shore Auto Parts Co.* v. *Korzen*, 49 Ill. 2d 137, 273 N.E. 2d 592 (1971). After this Court granted certiorari, the State of Illinois enacted a statute directing that the disputed property taxes be deposited in an interest-bearing escrow account pending final resolution of the *Lake Shore* case, and that full repayment would be made to the taxpayers "for whom such tax payments are placed in escrow" if the taxes were "ultimately held to be invalid" (Pet. App. A-3, A-27). Ill. Ann. Stat. ch. 120, § 676.01 (Smith-Hurd Cum. Supp. 1981). On July 7, 1972, petitioner paid to the County Collector of Montgomery County, Illinois, $26,110.32 in satisfaction of the 1971 personal property taxes owed by petitioner's individual stockholders on their bank shares. On the 1972 tax return, petitioner claimed a deduction for these tax payments pursuant to Section 164(e) of the Internal Revenue Code of 1954 (26 U.S.C.) (Pet. App. A-3 to A-4).[1]

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[1] Section 164(e) (see Pet. 7) provides that where a corporation pays a tax imposed on a shareholder on his interest as a shareholder and is not reimbursed for such payment, the corporation (and not the shareholder) is allowed the deduction provided for by Section 164(a).

In February 1973, this Court reversed the Illinois Supreme Court, holding that the Illinois constitutional amendment was valid. *Lehnhausen* v. *Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973). Acting upon the advice of the Illinois State's Attorney and the Illinois Department of Local Government Affairs, the County Treasurer of Montgomery County, Illinois, in 1973, refunded $26,697.79 (representing the $26,110.32 in erroneously collected personal property taxes, plus $587.47 in accrued interest) directly to petitioner's individual stockholders. Petitioner did not include in income any portion of the refunded amount on its return for its taxable year ended December 31, 1973 (Pet. App. A-28 to A-29).

On audit, the Commissioner determined that the entire sum refunded to petitioner's shareholders was includible in petitioner's gross income for 1973 under the tax benefit rule. In this action brought by petitioner to contest the Commissioner's determination, the Tax Court ruled that the refunded personal property taxes (but not the accrued interest) were properly includible in petitioner's income for 1973 (Pet. App. A-21 to A-46).

The court of appeals affirmed, with one judge dissenting (Pet. App. A-1 to A-20). Adhering to its earlier decision in *First Trust & Savings Bank of Taylorville* v. *United States*, 614 F.2d 1142 (1980), in which the tax benefit rule was applied under nearly identical circumstances, the court held that the tax benefit rule should be applied where "there is either an actual recovery of a previously deducted amount or some other event inconsistent with that prior deduction," and that the latter ground "applies foursquare in this case" because the state tax refund had "transformed a tax payment deductible under Sec. 164(e) into a nondeductible cash dividend to the Bank's stockholders" (Pet. App. A-7 to A-8).

DISCUSSION

1. The decision below correctly held that petitioner was required to restore to income the state taxes it previously paid and deducted when those taxes were refunded directly to its stockholders.

One of the fundamental principles upon which the federal system of income taxation is founded is the annual accounting system. Section 441 of the Internal Revenue Code of 1954 (26 U.S.C.); *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359 (1931). As this Court stated in *United States* v. *Consolidated Edison Co.*, 366 U.S. 380, 384 (1961): "It is settled that each 'taxable year' must be treated as a separate unit, and all items of gross income and deduction must be reflected in terms of their posture at the close of such year."

The annual accounting system draws arbitrary lines between taxable years. As a result, situations necessarily arise in which certain items that are properly reported as income at the close of one accounting period will not ultimately be enjoyed because the recipient becomes obligated to return such amounts during a subsequent accounting period. Conversely, expenses properly deducted on a return might be repaid to the taxpayer during a later accounting period. The proper remedy for correcting what is only later shown to be an overstatement of income or deductions is generally not to amend or modify the original return, but rather to reflect the change on the return covering the period during which the correcting transaction actually occurred. See, *e.g.*, *Burnet* v. *Sanford & Brooks Co.*, *supra*, 282 U.S. at 365; *Healy* v. *Commissioner*, 345 U.S. 278, 284 (1953).

One of the principles developed by the courts to deal with such subsequent year reportings is the "tax

benefit rule." That principle is designed to ensure a measure of tax parity in the effects of the earlier return and the later correcting return. Under the tax benefit rule, the required correction for expenses that are deducted but not ultimately incurred is for income for the later year to be increased by the amount of the prior deduction.[2] *Rosen* v. *Commissioner*, 611 F.2d 942, 943 (1st Cir. 1980). It has long been established that the tax benefit rule has particular application where previously deducted taxes are later refunded. See *Rothensies* v. *Electric Battery Co.*, 329 U.S. 296, 298 (1946).

2. The court of appeals correctly applied the tax benefit rule in this case which involves circumstances nearly identical to those present in its prior decision in *First Trust*.[3] In that earlier case, the court reaffirmed its support for the principle established more than 40 years ago in *Estate of Block* v. *Commissioner*, 39 B.T.A. 338 (1939), aff'd, 111 F.2d

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[2] While the "tax benefit rule" originated as a judicially-devised principle of general application, it has received statutory recognition in the form of the provisions now set forth in Section 111 of the Code. That statute, however, does not, by its terms, codify the rule itself, but serves only to limit the amount of the subsequent inclusion to that portion of the prior deduction that led to an actual tax benefit. See H.R. Rep. No. 2333, 77th Cong., 2d Sess. 45 (1942).

[3] The only distinction between the two cases is that the refund checks in *First Trust* were made out jointly to the bank and its shareholders while in the present case they were issued directly to the shareholders. That is a distinction without a difference because, as the court of appeals noted (Pet. App. A-6), the bank in *First Trust* was obligated to endorse over those refund checks to its individual stockholders. See *Lincoln National Bank* v. *Cullerton*, 18 Ill. App. 3d 953, 958-959, 310 N.E. 2d 845, 849 (1974).

60 (7th Cir.), cert. denied, 311 U.S. 658 (1940), that either " 'recovery or some other event which is inconsistent with what has been done in the past' " is sufficient to trigger application of the tax benefit rule (614 F.2d at 1145). After noting that the Sixth Circuit in *Tennessee-Carolina Transportation, Inc.* v. *Commissioner*, 582 F.2d 378 (1978), cert. denied, 440 U.S. 909 (1979),[4] recently subscribed to the "inconsistent event" test, the court concluded in *First Trust* (614 F.2d at 1146; footnotes omitted):

> We agree with the Sixth Circuit that the occurrence of an event inconsistent with a prior deduction is, in appropriate circumstances, sufficient to invoke the tax benefit rule. The inconsistency in the case before us is manifest. To allow the Bank a deduction for personal property taxes paid without subjecting it to income tax when its payment is refunded is to produce precisely the sort of windfall which the tax benefit rule is designed to preclude.

The situation here is, for all practical purposes, identical to that of *First Trust*. Pursuant to Section 164(e) of the Code, petitioner deducted in 1972 its

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[4] In *Tennessee-Carolina Transportation, Inc.*, a subsidiary corporation had purchased, and fully deducted the cost of, certain tires and tubes used in the operation of its business. When the subsidiary was liquidated into its new parent, the parent claimed a "stepped-up" basis in the tires and tubes reflecting their fair market value pursuant to Section 334(b)(2) of the Internal Revenue Code of 1954. The Sixth Circuit held that the subsidiary was required to include in its income the value of the tires and tubes it distributed in liquidation. The court concluded that the inconsistency between the earlier expense deduction, and the later distribution of valuable assets taking a "stepped-up" basis, warranted application of the rule (582 F.2d at 382).

payment of its individual shareholders' personal property taxes on their shares of its stock. After this Court rendered its decision in *Lehnhausen* v. *Lake Shore Auto Parts Co.*, *supra*, the taxes paid were refunded to the shareholders. At that point it was established that petitioner had received a deduction on a factual premise (that the shareholders were liable for the tax) that was no longer valid. Therefore, just as in *First Trust*, application of the tax benefit rule is necessary here to remedy the inconsistency created upon the refund by requiring petitioner to pay tax on the amount previously deducted, even though it was the bank's shareholders, rather than the bank itself, that recovered the refund.[5]

In effect, as the court of appeals noted (Pet. App. A-8), the distributed refunds to the individual shareholders here were nondeductible dividends.[6] It simi-

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[5] Contrary to petitioner's contention (Pet. 12), the court below did not "ignore" this Court's decision in *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394 (1972). In that case, this Court ruled that the Commissioner could not allocate income under Section 482 of the Code to certain banking subsidiaries of a holding company where such subsidiaries did not receive and were legally prohibited from receiving the income in question. The present case, however, in no way involves an allocation of income, under Section 482 or otherwise, among related parties. Rather, the Commissioner's position here is based on the fact that petitioner has enjoyed the benefit of a deduction that was no longer justified once it was determined that the taxes in question were not owing and they were refunded to the shareholders on whose behalf they had been paid. *First Security Bank of Utah*, therefore, has no application to this case.

[6] Petitioner asserts (Pet. 17) that a corporation may not pay dividends unless they have been declared by its board of directors and that they must be distributed to all stockholders of the same class on a pro-rata basis. It is well settled, how-

larly characterized the refund checks in *First Trust* as constructive dividends. As the court there stated (614 F.2d at 1147):

> But, of course, the distributed refunds were corporate dividends, taxable to the stockholders when received, but, nevertheless, nondeductible expenses to the Bank under our familiar system of "double taxation" at both the corporation and shareholder level. I.R.C. §§ 316, 301. Thus, unless the deduction previously taken is reversed (by taxing the amount of the refund), the Bank will, in effect, have benefited from a deduction taken for a nondeductible distribution. We cannot countenance such an anomalous result.

3. We agree with petitioner (Pet. 11) that the decision below conflicts, at least in principle, with *Bliss Dairy, Inc.* v. *United States*, 645 F.2d 19 (9th

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ever, that for federal tax purposes, dividend distributions may take many forms, and need not be formally declared or even intended. See, *e.g.*, *Baumer* v. *United States*, 580 F.2d 863, 876 (5th Cir. 1978); *Honigman* v. *Commissioner*, 466 F.2d 69, 73 (6th Cir. 1972). See also *Commissioner* v. *Gordon*, 391 U.S. 83, 89-91 (1968). See generally B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 7.05, at 7-27, 7-28 (4th ed. 1979). Moreover, a corporation may make such distributions disproportionately to its stockholders without affecting their classification as dividends. *Dynamics Corp. of America* v. *United States*, 392 F.2d 241, 245 (Ct. Cl. 1968); *General Aggregates Corp.* v. *Commissioner*, 313 F.2d 25, 28 (1st Cir.), cert. denied, 375 U.S. 815 (1963); *Regensburg* v. *Commissioner*, 144 F.2d 41, 44 (2d Cir.), cert. denied, 323 U.S. 783 (1944). Petitioner's complaint (Pet. 17-18) that it had no control over the refund distribution to its shareholders is irrelevant. As the court of appeals noted (Pet. App. A-8), "[t]he point is that the taxpayer has gained a windfall by taking a deduction that later developments show to have been unjustified."

Cir. 1981), which is presently pending before the Court on our petition for certiorari (No. 81-9[illegible]). There, the Ninth Circuit ruled that a liquidating corporation that had previously deducted the cost of cattle feed was not required to include any amount in income with respect to the value of unconsumed feed distributed to its shareholders since the corporation itself received no economic benefit upon the transfer of assets. In rejecting the application of the tax benefit rule in such circumstances, the court determined that the case was controlled by its prior decision in *Commissioner* v. *South Lake Farms, Inc.*, 324 F.2d 837 (1963), where it had similarly indicated that the tax benefit rule could not be applied to require any inclusion in gross income of previously deducted expenses incurred with respect to unharvested crops transferred on liquidation to the parent corporation that had recently acquired all of the taxpayer's stock. Although it acknowledged that its holding conflicted with that of the Sixth Circuit in *Tennessee-Carolina*, as well with as those of the Seventh Circuit in *First Trust* and the instant case, the court in *Bliss Dairy* declined to reconsider its prior ruling in *South Lake Farms*.[7]

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[7] The government had argued there (as well as in its brief in opposition to certiorari in *Tennessee-Carolina*) that the discussion of the tax benefit rule in *South Lake Farms* was dicta because the only issues squarely presented there were whether the Commissioner had the authority under Section 446 of the Code to require a change in that taxpayer's accounting method so as to require it to recognize the value of its unharvested crops, and whether, in the alternative, he had authority under Section 482 to deny the growing expense deductions. Moreover, we pointed out that the Ninth Circuit's decision in *South Lake Farms* was, at all events, undermined by its later decision in *Home Savings & Loan Association* v.

Because of the square conflict between *Bliss Dairy* and *Tennessee-Carolina*, as to the proper application of the tax benefit rule where a liquidating corporation distributes to its shareholders property that it has previously "expensed," we have sought certiorari in *Bliss Dairy*.[8] The Internal Revenue Service advises that there are at least 15 cases pending administratively, involving approximately $1.7 million in revenue, that present this issue in factual contexts similar to those involved here or in *Bliss Dairy*.[9] Although this case and *Bliss Dairy* present the same legal question whether the tax benefit rule applies in the absence of an actual physical recovery by the taxpayer of the amount previously deducted, they present that question in substantially different fac-

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United States, 514 F.2d 1199 (1975). While the Seventh Circuit agreed with that assessment (see *First Trust*, *supra*, 614 F.2d at 1146 n.5), the Ninth Circuit itself did not. The Ninth Circuit, however, has recently cited *First Trust* with approval in *Unvert* v. *Commissioner*, 656 F.2d 483 (1981). There, the court held that the refund of interest paid and previously deducted improperly was taxable in the year of the refund under the tax benefit rule. Although the taxpayer there gained an actual recovery, the Ninth Circuit appeared to approve the Seventh Circuit's formulation of the tax benefit rule. See pages ——— of our petition in *Bliss Dairy*, No. 81-930.

[8] We are serving a copy of this response on counsel for the respondent in *Bliss Dairy*.

[9] The question whether the tax benefit rule applies in the absence of an actual physical recovery by the taxpayer in question has been litigated six times since 1978. In addition to *Tennessee-Carolina*, *First Trust*, *Bliss Dairy* and the instant case, see *Bonaire Development Co.* v. *Commissioner*, 789 (1981), appeal pending, No. 81-7469 (9th Cir.), and *Ballou Construction Co.* v. *United States*, No. 79-4138 (D. Kan. Aug. 4, 1981), appeal pending, No. 81-2155 (10th Cir.).

tual contexts. We believe that it would be helpful for the Court to consider the application of the tax benefit rule in both contexts. We therefore do not oppose the petition in this case. The Court may wish to consolidate this case with *Bliss Dairy* (No. 81-930) for purposes of briefing and oral argument.

It is therefore respectfully submitted that the petition for a writ of certiorari should be granted.

REX E. LEE
Solicitor General

NOVEMBER 1981

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Petitioner's Brief

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BRIEF FOR THE PETITIONER

HARVEY B. STEPHENS
MARK H. FERGUSON
ROBERT A. STUART
Brown, Hay & Stephens
700 First National Bank Bldg.
P.O. Box 2459
Springfield, Illinois 62705
(217) 544-8491
Attorneys for Petitioner.

SCHNEPP & BARNES PRINTERS, INC., SPRINGFIELD, ILL.

QUESTION PRESENTED FOR REVIEW

Is a taxpayer required to include in its taxable income state taxes deducted in one year that are refunded by the collector to other persons in a later year, where the taxpayer did not receive the refund, direct the refund, know that the refund had been made, or receive any benefit as a result of the refund?

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BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the U.S. Court of Appeals for the Seventh Circuit is reported at 641 F. 2d 529 (1981) and is reproduced in the Appendix to the Petition for Writ of Certiorari, at page A-1. The opinion of the United States Tax Court is reported at 73 T.C. No. 5, and is reproduced in the Appendix to the Petition, at page A-21.

JURISDICTION

The judgment of the U.S. Court of Appeals for the Seventh Circuit was entered on February 25, 1981, with one member of the three-judge panel dissenting. A timely Petition for Rehear-

ing and Suggestion for Rehearing in Banc was denied on June 9, 1981, with two members dissenting. This Court granted the Petition for Writ of Certiorari on January 18, 1982.

STATUTES AND REGULATIONS INVOLVED

The following statutes and regulations are reproduced in the Appendix:

Internal Revenue Code of 1954, as amended, Section 111, 26 U.S.C.A. Sec. 111.

Internal Revenue Code of 1954, as amended, Section 164, 26 U.S.C.A. Sec. 164(e).

Illinois Revised Statutes, 1971, Chapter 120, Paragraph 557.

Illinois Revised Statutes, 1971, Chapter 120, Paragraph 558.

Illinois Revised Statutes, 1971, Chapter 120, Paragraph 676.01.

Treasury Regulations, Section 1.111-1(a)(2).

STATEMENT OF THE CASE

Prior to January 1, 1971, local taxing districts in Illinois, where either state or national banks were located, taxed all of the shareholders without regard to residence on the value of their shares of stock. On November 3, 1970, the voters of Illinois adopted, effective January 1, 1971, an amendment to the Constitution of 1870 which prohibited the taxation of personal property owned by individuals by valuation. Litigation insued challenging the validity of this amendment. On July 9, 1971, the Illinois Supreme Court held the amendment unconstitutional, in *Lake Shore Auto Parts v. Korzen*, 49 Ill. 2d 137, 273 N.E.2d 592 (1971). This Court in February, 1973, in *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356, 93 S. Ct. 1001, 35 L. Ed. 2d 351 (1973) *rehearing denied*, 411 U.S. 910 (1973) reversed the Illinois Supreme Court and upheld the amendment to the Illinois Constitution.

In 1971, while this litigation was pending, the Montgomery County treasurer assessed a tax on the value of the stock owned by the shareholders of the Hillsboro National Bank. On July 7, 1972, the Hillsboro National Bank paid to the Montgomery County Treasurer $31,424.55, being the 1971 personal property taxes imposed on its shareholders whether individuals, corporations, trusts, estates or others. The entire amount of this tax was paid out of the general funds of the Bank and was not paid from dividends, nor did the Bank withhold any dividends as a result of the tax payment. The total amount paid was deducted by the Hillsboro National Bank on its 1972 federal corporate income tax return pursuant to Section 164(e) of the Internal Revenue Code, which permits a corporation to deduct a tax imposed on the interest of a shareholder it pays and prohibits the shareholder from deducting said tax. For a number of years prior to 1972, Hillsboro National Bank, as well as other banks in Illinois, had paid the personal property tax assessed against their shareholders' interest.

After the payment of these taxes by the taxpayer, Hillsboro National Bank, the Illinois General Assembly amended the Revenue Act, effective July 27, 1972, by adding a special provision which directed the county collector to hold in escrow all payments of *ad valorem* personal property taxes by natural persons pending resolution of the above litigation. Ill. Rev. Stat., Ch. 120, Sec. 676.01

Following the *Lehnhausen* decision by this Court in 1973, the treasurer of Montgomery County, without consultation with the Hillsboro National Bank, upon the advice of the Illinois Attorney General and the Illinois Department of Local Government Affairs, issued refunds totalling $26,110.32 to 132 of the 149 shareholders of the Bank. No refunds were made to the Bank, which had paid the taxes, or to those shareholders who the treasurer determined were not natural persons. The treasurer alone determined the amount of the refunds. The checks were payable and delivered *solely* to the individual shareholders; the Bank was not a joint payee. The Bank did not receive the checks, and did not know the amount of each shareholder's refund or the total amount refunded by the treasurer. In addition to the refunded taxes, the treasurer determined that interest earned on the tax payments while they were being held pending the litigation was payable to the individual shareholders.

The Hillsboro National Bank made no claim for the amounts refunded to its shareholders. No entries were made in the books or the records of the Bank to account for the payments from the treasurer to the individual shareholders. The current earnings and profits of the Bank exceeded the personal property taxes paid by the Bank in 1972, and the payment of the taxes and the subsequent refund to selected shareholders did not alter the Bank's historic dividend policy.

On August 5, 1976, the Commissioner of Internal Revenue issued a statutory notice of deficiency based upon the Petitioner's failure to include as taxable income for 1973, the monies

paid to its shareholders by the Montgomery County Treasurer. Petitioner filed a petition with the Tax Court which upheld the Commissioner's position on January 8, 1980. Petitioner appealed to the Court of Appeals for the Seventh Circuit pursuant to Section 7482(a) of the Internal Revenue Code of 1954. The Circuit Court of Appeals upheld the Tax Court, and a Petition for Certiorari was filed with the United States Supreme Court. On January 18, 1981, this Court granted the Petition for Certiorari.

SUMMARY OF ARGUMENT

The taxpayer, Hillsboro National Bank, should not be required to include in its income the amount of Illinois personal property taxes refunded to its shareholders by the Montgomery County, Illinois, treasurer. Although the Bank enjoyed a tax benefit when it deducted the taxes paid on behalf of its shareholders in 1972, the Bank did not recover those taxes when they were refunded to other taxpayers.

A recovery of an economic benefit is required before the tax benefit rule can be applied to a taxpayer. This taxpayer did not recover *any* benefit, either directly or indirectly, when the property taxes were refunded to its shareholders by the local officials. It did not direct that the refunds be so distributed, and did not even know the amounts until after they were distributed. There was no economic benefit enjoyed by the Bank as a result of the refunds; its liabilities, earnings and net worth were the same before and after the refunds.

The Commissioner applys an "inconsistent event" theory as a substitute for the recovery requirement of the tax benefit rule. The Court of Appeals decision herein was the first time a taxpayer has been found to have taxable income *solely* on the basis of an event that is allegedly "inconsistent" with a prior deduction. There is no support for the Commissioner's position in the philosophy or history of the tax benefit rule.

Although the Commissioner maintains that a constructive dividend was distributed to Bank shareholders, such a characterization is a revolutionary and improper application of constructive dividend theory, because neither the Bank or its shareholders had any control or influence on the distribution of the monies by the County Treasurer. Such a change in an income tax concept is only within the province of Congress, and is not for administrative application on a case-by-case basis.

ARGUMENT

A. INTRODUCTION.

At the core of the federal income tax is the simple policy determination that a taxpayer should include in its gross income amounts of income realized, or received, each taxable year. The corollary is that a taxpayer need not include unrealized income, or income not received. The Commissioner's attempt to require the Petitioner, Hillsboro National Bank, to include tax refunds it did not directly or indirectly receive would violate the latter concept by taxing the bank on income it did not and could not enjoy.

The general rule that the absence of receipt has no taxable consequences has been statutorily and judicially modified to take into account situations where actual receipt of cash is absent, but receipt of some economic benefit has occurred. These modifications have been used by the government to prevent manipulation of events by taxpayers to their ultimate tax advantage. Thus, for example, the doctrine of assignment of income prevents avoidance of income tax through conscious avoidance of actual receipt. The concept of "constructive dividends" has prevented corporations from diverting otherwise non-deductible cash dividends to their shareholders in the guise of deductible salaries or other benefits. These exceptions were designed to prevent tax avoidance schemes by clever taxpayers. They were not designed to change the general rule that income not received and not in any way controlled by a taxpayer should nevertheless be taxed to him.

More specifically, the exceptions to the requirement of actual receipt have not been applied to situations like the instant case, where the taxpayer itself (1) did not dominate or control a transaction to the extent of influencing tax consequences; (2) did not act in collusion with a related or commonly-controlled entity to manipulate receipt of income, and (3) was unrelated

to and completely disassociated from the third party (the County treasurer) who completely controlled the disposition of the refunds.

The Commissioner's version of the tax benefit rule would plainly violate the principle that receipt, actual or constructive, is required to trigger a tax income. Quite simply, the Bank here has received no benefit, economic or otherwise, as a result of the refunds of Illinois personal property taxes. It received no cash; no dividends were indirectly distributed to its shareholders; its liabilities were not decreased; its net worth was not increased; it did not attempt to divert income that it earned to another taxpayer. Yet the Commissioner, the Tax Court, and the Seventh Circuit have determined that the Bank, although it received nothing of value, should include the monies distributed by the County Treasurer as income. Such a result was not intended by the courts that developed and properly applied the tax benefit rule, nor was it intended by Congress when it statutorily endorsed the rule.

The principle advanced by the Petitioner echoes a previous statement of this Court. In *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, 92 S. Ct. 1085, 31 L. Ed. 2d 318 (1972), the Commissioner sought to attribute income received by a related taxpayer to the taxpayer before the Court. Here, the Commissioner seeks to attribute income received by Bank shareholders to the Bank. The Court said:

> "We know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving. In cases dealing with the concept of income, it has been assumed that the person to whom the income was attributed could have received it. The underlying assumption always has been that in order to be taxed for income, a taxpayer must have complete dominion over it. 'The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.'

Corliss v. Bowers, 281 U.S. 376, 378; 50 S. Ct. 336; 74 L. Ed. 916, 918 (1930)." 31 L. Ed. 2d 318, 326.

Although the tax benefit rule was not an issue in *First Security Bank*, *supra*, the principle involved here is the same: a taxpayer should not be taxed on amounts it did not and could not receive.

B. APPLICATION OF THE TAX BENEFIT RULE IS PREDICATED UPON THE TAXPAYER'S DIRECT OR INDIRECT RECEIPT OF AN ECONOMIC BENEFIT.

The Petitioner Bank does not deny that it received a tax benefit in 1972, when it properly paid and deducted personal property taxes assessed on the stock of its shareholders. The deduction reduced the Bank's taxable income and its tax. But after the tax payments were made, the Bank no longer controlled or influenced disposition of the tax payments. The Montgomery County treasurer, an unrelated third party, was in complete control of disposition, and he decided to refund the taxes to the shareholders; when he did so, the Bank was not consulted or notified. The shareholders who received refunds were determined by the treasurer, as was the amount of each payment.

The Commissioner asserts that because the Bank enjoyed a 1972 tax benefit, and because the taxes were not disposed of in the expected manner, the later refunds, *to whomever they were made*, were "inconsistent" with the earlier deduction by the Bank. Solely on the basis of this "inconsistency", and relying on dicta in three Court decisions, the Commissioner asserts that the tax benefit rule requires the Bank to increase its taxable income for 1973 by the amount of the refunds to its shareholders.

Petitioner does not dispute the validity of the tax benefit rule itself, that an expense, loss or other payment that generated a deduction and resulting tax decrease in an earlier year must be included as income in the year it is refunded or otherwise

recovered by the taxpayer. That rule was confirmed by this Court in *Burnet v. Sanford & Brooks Co.*, 282 U.S. 259, 51 S. Ct. 150, 75 L. Ed. 383 (1931), in which the taxpayer was required to include amounts representing recovery of business expenses and losses incurred and deducted in an earlier year. The reasoning therein was later applied by the Tax Court and Courts of Appeals, including the Seventh Circuit in *Nash v. Commissioner*, 88 F. 2d 477 (7th Cir. 1937), *cert. denied*, 301 U.S. 700 (1937) and in *Union Trust Co. v. Commissioner*, 111 F. 2d 60 (7th Cir. 1940).

The first statutory recognition of the tax benefit rule was in the form of a limitation on its scope, prompted by the Commissioner's determination to include recoveries of previously deducted amounts regardless of whether the deduction resulted in an actual reduction in tax. See G.C.M. 22163, C.B. 1940-2, 76. Thus, in 1942, Section 22(b)(12) was added to the Internal Revenue Code of 1939 to provide for an exclusion from income of recoveries of certain items to the extent they did not produce a tax benefit when deducted in an earlier year. Although the statute referred only to the recovery of bad debts, taxes and delinquency amounts, this Court and later Treasury regulations extended the exclusion to recoveries of all previously deducted items. *Dobson v. Commissioner*, 320 U.S. 489, 64 S. Ct. 239, 88 L. Ed. 248 (1943); Treasury Regulations, Section 1.111. The statutory provision was recodified in Section 111 of the Internal Revenue Code of 1954.

The origin of the "inconsistent event" theory that the Commissioner now relies on to avoid the recovery requirement of the tax benefit rule was in the opinion of the Board of Tax Appeals in *Block v. Commissioner*, 39 B.T.A. 338 (1939), *aff'd sub nom., Union Trust Company v. Commissioner*, 111 F. 2d 60 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940). Although the facts of the case—involving a refund of estate taxes deducted in an earlier year—required nothing more than a straightforward application of the tax benefit rule, the Board, in dicta, stated

that the tax benefit rule should be applied "(w)hen recovery or some other event which is inconsistent with what has been done in the past occurs". The Court of Appeals in affirming the Board does not discuss this statement.

The Commissioner relies on two cases where a court purportedly relied on the theory of "inconsistent event" hypothesized in *Block*, to uphold inclusion of a recovery in income: *Tennessee-Carolina Transportation, Inc. v. Commissioner*, 582 F. 2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909, 99 S. Ct. 1219, 59 L. Ed. 2d 457 (1979), and *First Trust & Savings Bank v. United States*, 614 F. 2d 1142 (7th Cir. 1980). In each of these cases the Courts of Appeals found an actual recovery of a previously deducted amount.

In *Tennessee-Carolina Transportation, Inc.*, the taxpayer purchased all of the stock of Service Lines, Inc. (Service), which the taxpayer thereafter operated as a subsidiary and later liquidated. Among the assets distributed to taxpayer on liquidation were tires and tubes purchased by Service for its own use. Service had properly deducted the entire cost of the tires and tubes on its return for the year in which they were purchased, thereby reducing Service's basis in them to zero.

Upon distribution of the assets to it in exchange for its stock in Service, the taxpayer allocated its basis in the stock to the various assets received, including the tires and tubes, in accordance with Code Section 334. The amount of the taxpayer's basis in the tires and tubes was thereafter properly deducted by taxpayer on its return for the year the assets were received.

The Commissioner maintained that Service should have included in its income the value of the tires and tubes at the time

they were transferred to the taxpayer, on the basis of the tax benefit rule. Although the Sixth Circuit upheld the Commissioner's application of the rule, and cited the "inconsistent event" theory announced by the Board of Tax Appeals in *Block v. Commissioner*, 39 B.T.A. 338 (1939), the majority found that Service had indirectly received a benefit when the tires and tubes were transferred to the taxpayer. There was, in the majority's view, an actual recovery that justified the addition to Service's income. It stated:

> "Second, even if a 'recovery' is required to apply the tax benefit rule, there was such a recovery here. When the tires and tubes were expensed by Service they were, in contemplation of the tax laws, completely consumed. They had a zero basis and were considered a nonentity, but only in contemplation of their actual consumption by Service. At the time of the liquidation, an event of significance in the tax laws, they were transferred to taxpayer as a usable entity. This transfer belied the assumption that they would be wholly consumed by Service. Thus, in order for Service to be able to transfer them to taxpayer, they must be deemed to have been recovered by Service at that time, as the Tax Court held. Taxpayer objects to this, claiming it is a "fictional" recovery. In a sense, it is fictional but certainly no more so than the initial fiction that the tires and tubes would be completely consumed by Service in about one year in order to justify their being expensed. Taxpayer cannot equitably argue that Service should have the benefit of fictionally converting the tires and tubes into a nonentity (by expensing them) yet not have the burden of having them fictionally reconverted into tangible property (by applying the tax benefit rule).
>
> "Third, again assuming there need be an actual 'recovery' in order to apply the tax benefit rule, there was a recovery here in another sense. Service received its own stock in exchange for the assets transferred to taxpayer. It is true that this stock had no value after the liquidation was completed, but it had considerable value at the time it was returned to Service. This is enough to satisfy any need for a 'recovery' by Service in order to apply the tax benefit rule." 582 F. 2d 378, 382.

By allocating its basis in the Service stock to the various assets received on liquidation, the taxpayer impliedly recognized that part of the price paid for the stock was paid for the assets of Service, and that part of the price paid represented the value of the tires and tubes. By transferring the tires and tubes in exchange for an allocable portion of its stock, Service recovered the value of the tires and tubes. Because the earlier deduction had reduced the tax liability of Service, it was required to recapture the deduction to the extent of the value received for the tires and tubes.

The other case relied upon by the Commissioner is *First Trust & Savings Bank v. United States*, 614 F. 2d 1142 (7th Cir. 1980), which arose out of the same factual background as this case, *i.e.*, a refund of Illinois personal property taxes. When the County Treasurer made the personal property tax refunds, the checks were made payable to the bank and the shareholders and were delivered to the bank. As the Seventh Circuit stated,

> "even if an actual 'recovery' by the Bank is viewed as essential to the application of the (tax benefit) rule, we find such a recovery here. The Bank admittedly 'received' the refunded taxes, in checks payable jointly to it and its stockholders." 614 F. 2d 1142, 1146.

The fact that the bank in *First Trust* received the refund checks as a joint payee distinguishes that case from the one now before the Court.

The facts of this case do not resemble those in *Tennessee-Carolina Transportation, Inc.* There was no recovery of any kind in this case, as the Bank received nothing when the property taxes were refunded to its shareholders. It received no cash and no other benefit, by discharge of a liability, redemption of its stock or otherwise. As for *First Trust*, to the extent that the three-judge panel of the Seventh Circuit would have required inclusion in the bank's income regardless of whether the bank actually received the refund checks, Petitioner asserts that *First Trust* does not correctly state the law and should be overruled.

Absent receipt by the bank, there would have been no direct or indirect recovery by the taxpayer there, as there was none here.

The Commissioner's "inconsistent event" theory has been rejected by the Ninth Circuit in *Commissioner v. South Lake Farms, Inc.*, 324 F. 2d 837 (9th Cir. 1963) and in *Bliss Dairy, Inc. v. United States*, 645 F. 2d 19 (9th Cir. 1981), which has been consolidated with this case in this Court. Both cases involved facts similar to those in *Tennessee-Carolina Transportation, Inc. v. Commissioner*, 582 F. 2d 378 (6th Cir. 1978), *cert. denied*, 440 U.S. 909 (1979), and are in direct conflict with its result. The Ninth Circuit has refused to apply the tax benefit rule even to the extent of taxing recovery of an indirect benefit. Its reasoning should be applied with greater force to a case such as this, where there is no recovery of any benefit whatever.

In both *South Lake Farms, Inc.* and *Bliss Dairy, Inc.*, the Court rejected attempts to attribute to a corporation the gains of its shareholders. Although both of those cases involved corporate liquidations, the position of the Commissioner here would accomplish the same result attempted there: the attribution of gains of shareholders to their corporation.

The Commissioner made the same argument in *South Lake Farms, Inc.* that was later accepted by the Court in *Tennessee-Carolina Transportation, Inc., i.e.*, that on liquidation of a subsidiary corporation, the purchase price of the subsidiary's stock should be considered proportionately attributable to items that had current value, including those that generated previous deductions. But the Ninth Circuit rejected the argument because the *corporation* had no recovery, stating:

> "One immediate difficulty with (the Commissioner's) position is that the old corporation received nothing. It was the stock of the old corporation that was sold, and the stockholders who got the money. The price that they got was higher because of the values added to the old corporation's assets by the expenditures that were made in preparing the barley lands and in preparing, planting, and

> growing the cotton crop. No doubt they paid tax on the increased gain. *Nowhere in the Code do we find an intent that gains of the stockholders were to be attributed to the corporation*, much less that they were to be treated as ordinary income to the corporation. The corporation is to be taxed only on its own income." (Emphasis added) 324 F. 2d 837, 839.

The result and reasoning of *South Lake Farms, Inc.* was reaffirmed in *Bliss Dairy, Inc.*

In *Tennessee-Carolina Transportation, Inc.* and *First Trust*, both of which are in conflict with other decisions, the majorities were not content to rely on the "inconsistent event" theory and found actual recoveries, which are in no way present here. As the dissenting opinion in *Tennessee-Carolina Transportation, Inc.* stated:

> "Neither the majority, the majority of the Tax Court, nor the Commissioner has cited a single case in which the tax benefit rule has been applied solely on the basis of the occurrence of an event which was inconsistent with a previous deduction. To the contrary, the salient feature of every case cited by them, in which the rule was applied, is the presence of an actual economic recovery by the taxpayer, either (1) by way of receipt of funds, (citations omitted) or (2) by way of a discharge of an accrued liability, resulting in an increase in the taxpayer's net worth, (citations omitted)." 582 F. 2d 378, 384.

In every case in which the tax benefit rule has been applied, the taxpayer has had an actual economic recovery, albeit sometimes an indirect recovery rather than actual receipt of cash. Because the taxpayer here received no actual economic recovery whatever, the rule was improperly applied by the Tax Court and the Seventh Circuit.

Both the statutory reference to the tax benefit rule and the regulation thereunder recognize that recovery is necessary to the proper application of the rule. Section 111 of the Code states in part as follows:

> "(a) *General Rule.*—Gross income does not include income attributable to the *recovery during the taxable year* of a bad debt, prior tax, or delinquency amount to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount." (Emphasis added) I.R.C., Section 111.

Similarly, the regulations, in defining "recovery", state that:

> "Recoveries result from the *receipt of amounts* in respect of the previously deducted or credited Section 111 items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued." (Emphasis added) Reg. Section 1.111-1(a)(2).

Neither Congress nor the Treasury mentioned the "inconsistent event" theory now asserted by the Commissioner. In fact, because no mention is made in Section 111 of the theory, it could be argued that the exclusion will not apply where there is no actual recovery, as without recovery there arguably could be no recovery exclusion.

In *Nash v. United States*, 398 U.S. 1, 90 S. Ct. 1550, 26 L. Ed. 2d 1 (1970), this Court refused to apply the tax benefit rule to a taxpayer who did not have a recovery. In *Nash*, a partnership used the reserve method of accounting, under which deductions are taken based on changes in the reserve account during the taxable year instead of deducting bad debts within the year. The dispute arose when the partnership transferred its eight offices to eight corporations, in tax-free transfers under Section 351 of the Code. At the time of the transfers, the bad debt reserve on the partnership's books totalled $73,028.05, which presumably was the total of deductions taken by the partnership (and individual partners) in prior taxable years.

The Commissioner argued that the tax benefit rule required the partnership to include in income, in the year of its termination, the amount of the bad debt reserve because the partnership's "need" for the reserve ended at that time. This was based on the presumption that the deductions generated by the bad

debt reserve were only justified while the taxpayer-partnership could reasonably predict that some of its receivables would not be collected.

In effect, the Commissioner could have argued that the end of the "need" for the reserve was "inconsistent" with the earlier deductions, just as he now says the refunds to shareholders were "inconsistent" with the Bank's earlier deduction. This Court rejected the Commissioner's position, stating:

> "Congress could make the end of 'need' synonymous with 'recovery' in the meaning of the tax benefit rule. . . . The semantics would then be honored by the Commissioner's ruling. But we do not feel free to state the tax benefit rule in those terms in the present context." 398 U.S. 1, 3-4, 90 S. Ct. 1550, 26 L. Ed. 2d 1, 4.

Congress could have just as easily made other "inconsistent events" synonymous with "recovery" for purposes of the tax benefit rule. Unless and until it does so, the Commissioner should not be permitted to engraft a substitute for recovery into the tax benefit rule, as he attempts to do in this case. Nor should this Court abandon its holding in *Nash* to extend the ambit of the tax benefit rule.

C. THE PETITIONER DID NOT RECEIVE ANY ECONOMIC BENEFIT AS A RESULT OF THE TAX REFUNDS, AND RECEIPT SHOULD NOT BE ATTRIBUTED TO IT.

The federal system of income taxation is intended to tax persons on income they receive. While the Internal Revenue Code and case law have modified the requirement of *actual* receipt, the modifications have been made to accommodate situations in which income is earned by one taxpayer while it is actually received by another. *See, e.g., Lucas v. Earl*, 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731 (1930). The "assignment of income" and "constructive receipt" theories were developed to prevent taxpayers from diverting income to other, lower-bracket taxpayers, or from one taxable year to another.

The equitable results of these theories, when properly applied, cannot be denied. But they require facts indicating a conscious attempt by a taxpayer entitled to receive income to divert it, before receipt, to another. While the income is not actually received by the person taxed, the ability of that person to control the events that determine who will actually receive the income is sufficient to attribute receipt to that person. In short, a taxpayer cannot control the form of a transaction to such an extent that the substantive issue of taxation can be determined to the detriment of the government. *See e.g., Lucas v. Earl*, 281 U.S. 111, 50 S. Ct. 241, 74 L. Ed. 731 (1930); *Commissioner v. Culberston*, 337 U.S. 733, 69 S. Ct. 1210, 93 L. Ed. 1659 (1949); *Commissioner v. South Lake Farms, Inc.*, 324 F. 2d 837 (9th Cir. 1963) (Carter, J., dissenting).

The Commissioner concedes, as he must, that the Bank properly deducted the personal property taxes it paid on behalf of its shareholders in 1972. Section 164(e) of the Internal Revenue Code specifically allows that deduction.* Based on

*Section 164(e) states as follows:

"(e) TAXES OF SHAREHOLDER PAID BY CORPORATION.—Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation, then—

(1) the deduction allowed by subsection (a) shall be allowed to the corporation; and

(2) no deduction shall be allowed the shareholder for such tax."

the stipulated facts, the Commissioner must also concede that the Bank did not actually receive the refunds of taxes in 1973, and did not control or influence their disposition. In fact, the Bank did not know that the refunds had been made.

The Commissioner attempts to apply the tax benefit rule in a manner that the facts do not support. What his attempt represents is a distorted variation of the assignment-of-income and constructive receipt theories in the absence of the facts required to justify their application.

The assignment-of-income doctrine and its justification were explained by Justice Holmes for this Court in *Corliss v. Bowers*, 281 U.S. 376, 50 S. Ct. 336, 74 L. Ed. 916 (1930). The taxpayer there challenged the validity of a Code provision requiring the grantor of a revocable trust to include income of the trust on his own return. Justice Holmes' opinion, upholding the tax statute, stated that:

> "... if a man disposes of a fund in such a way that another is allowed to enjoy the income which it is in the power of the first to appropriate, it does not matter whether the permission is given by assent or by failure to express dissent. The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not." 281 U.S. 376, 378; 74 L. Ed. 946, 917-18.

The fact that triggers income where receipt is absent is the power to control disposition of amounts representing income.

While equity and fairness in taxation justify the application of the doctrine of assignment of income in particular factual contexts, those situations stand in stark contrast to the inequity and infairness of the theory sought to be enforced against the Petitioner in this case. Here, the taxpayer did not assign income to another, it did not manipulate a transaction to its tax benefit, it did not divert income to another taxpayer, and it did not receive the amount on which the deficiency is based. In short, the Petitioner did nothing to justify an exception to the general rule that income will be taxed only to those who receive it.

The doctrine of constructive receipt has been used most often by the Internal Revenue Service and the courts where taxpayers have the *right* to receive income but purposely do not actually receive it until a later date. It has been used principally in the area of timing and accounting for income. Thus, a taxpayer with the unqualified right to receive income will be taxed in the year in which the right to it arose. The rule has been applied where a check has been received in one year but was not cashed until the next, *Lavey v. Commissioner*, 158 F. 2d 859 (7th Cir. 1946); where an agent received funds in one year but did not transfer them to his principal until the next, *Kamm's Estate v. Commissioner*, 349 F. 2d 953 (3d Cir. 1965); and to a bank employee who diverted bank funds to her account but did not write checks on the account, *Geiger's Estate v. Commissioner*, 352 F. 2d 221 (8th Cir. 1965).

Application of the constructive receipt theory to the Bank in this case is necessary to reach the result advocated by the Commissioner. In effect, he must establish (1) constructive receipt of the refunds by the Bank, and (2) subsequent constructive distribution by the Bank to its individual shareholders. But constructive receipt requires an unqualified right to actual receipt, which has been delayed only through the action of the taxpayer. Here, the Bank had no right to the refunds to begin with, a fact confirmed by Illinois courts. *See Lincoln National Bank v. Cullerton*, 18 Ill. App. 3d 953 (1st Dist. 1974) and *Bank & Trust Co. of Arlington Heights v. Cullerton*, 25 Ill. App. 3d 721 (1st Dist. 1975).

The second step of the Commissioner's argument is also unsupportable here. Section 301 of the Code requires all distributions by a corporation to a shareholder "with respect to its stock" to be treated as corporate distributions, and it admittedly covers "constructive" distributions even where dividends or returns of capital have not been formally declared. Constructive dividend distribution has been found in transactions between commonly controlled corporations, camouflaged

"loans" to shareholders, excessive corporate salaries, and bargain purchases from shareholder/employees. *See generally*, Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, Section 7.05 (1979 ed.). But here, as in the assignment-of-income cases, the results are dictated by corporate or shareholder manipulation of transactions to divert income from one taxpayer to another. Such manipulation is not present in this case.

If the Petitioner Bank had received the tax refunds from the county treasurer, the Bank would not contest the inclusion of the amounts in its income for 1973, the year the refunds were made. But the Bank did not receive the refunds, and was not even aware they were being made. It is the Bank's contention that the tax benefit rule should be triggered only when a taxpayer receives some economic benefit through the refund or recovery of an expense it previously deducted.

The Commissioner and the majority of the Seventh Circuit base their position on two misconceptions:

(1) That the taxpayer distributed a non-taxable cash dividend to its shareholders; and

(2) That the taxpayer somehow has gained a "windfall" as a result of the refunds.

Neither contention is supported by the law or by the facts.

The first contention is erroneous simply because the Bank distributed nothing to its shareholders. Neither the payment of the tax in 1972 nor its refund in 1973 altered the Bank's historic dividend policy. Implicit in the Commissioner's and the Court's conclusion in this regard is the assumption that, had the refunds been paid to the Bank, it would have distributed them to the shareholders as a cash dividend. This assumption ignores the legal reality, *i.e.*, that Bank shareholders could not have forced the Bank to distribute any dividends to them unless and until the Bank's Board of Directors declared a dividend.

The true weakness of the argument is that it concedes to the County treasurer the right and power to declare a dividend for the Bank. In the absence of facts indicating any sort of collusion between the Bank and the treasurer as to who should receive the refunds, or any evidence whatever that the Bank participated in any way in the refund scheme, the implied transfer to the treasurer of such dividend-declaration authority flies in the face of established principles of both corporate and taxation law.

For similar reasons, the second contention—that some "windfall" was enjoyed by the Bank—is unsupportable. Although the term "windfall" was used by the majority of the Court of Appeals here and by the Court in *First Trust & Savings Bank v. United States*, 614 F. 2d 1142 (7th Cir. 1980), at no point has the Court with any clarity explained what that "windfall" was because the Bank's position has not changed.

Certainly there was no "windfall" to the Bank when it paid the property taxes in 1972 and deducted the amount from its income. The Bank was secondarily liable for the tax under applicable Illinois law Ill. Rev. Stat. Ch. 120, Sec. 578, 579, and assumed the obligation to pay the tax under Section 164 of the Internal Revenue Code. The Commissioner did not perceive any "windfall" at that time, and he at no time has challenged the payment or the deduction. Since then the Petitioner has received nothing. If a "windfall" exists, it is to the shareholders not the Petitioner who the Commissioner now seeks to tax.

Petitioner concedes that, had it directly or indirectly recovered the taxes previously paid and deducted without including the amount of the recovery in its income, there would have been untaxed income to it to the extent of the reduction of its tax liability generated by the earlier deduction. But the fact is that the Bank did not recover, in any form, any of the previously paid taxes. No liability to its shareholders was discharged, its net worth was not increased, no benefit of any kind was enjoyed. It is still without the money it paid in property taxes, and never will recover it.

CONCLUSION

This case represents an attempt by the Commissioner to improperly collect a tax through misapplication of a valid rule of taxation. In the words of Judge Pell this "unwarranted and unfair ingenuity of the tax collectors" should not be sanctioned by this Court. Petitioner Hillsboro National Bank urges this Court to reverse the decision of the Court of Appeals for the Seventh Circuit.

Respectfully submitted,

HARVEY B. STEPHENS
MARK H. FERGUSON
ROBERT A. STUART
Brown, Hay & Stephens
700 First National Bank Bldg.
P.O. Box 2459
Springfield, Illinois 62705
(217) 544-8491
Attorneys for Petitioner.

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INTERNAL REVENUE CODE, SECTION 111:

SEC. 111. RECOVERY OF BAD DEBTS, PRIOR TAXES, AND DELINQUENCY AMOUNT.

(a) *General Rule.*—Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.

(b) *Definitions.*—For purposes of subsection (a)—

(1) *Bad Debt.*—The term "bad debt" means a debt on account of the worthlessness or partial worthlessness of which a deduction was allowed for a prior taxable year.

(2) *Prior Tax.*—The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior taxable year.

(3) *Delinquency Amount.*—The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior taxable year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.

(4) *Recovery Exclusion.*—The term "recovery exclusion", with respect to a bad debt, prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Secretary, of the deductions or credits allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this subtitle (not including the accumulated earnings tax imposed by section 531 or the tax on personal holding companies imposed by section 541) or corresponding provisions of prior income tax laws (other than subchapter E of chapter 2 of the Internal Revenue Code of 1939, relating to World War II

excess profits tax), reduced by the amount excludable in previous taxable years with respect to such debt, tax, or amount under this section.

(c) *Special Rules for Accumulated Earnings Tax and For Personal Holding Company Tax.*—In applying subsections (a) and (b) for the purpose of determining the accumulated earnings tax under section 531 or the tax under section 541 (relating to personal holding companies)—

(1) a recovery exclusion allowed for purposes of this subtitle (other than section 531 or section 541) shall be allowed whether or not the bad debt, prior tax, or delinquency amount resulted in a reduction of the tax under section 531 or the tax under section 541 for the prior taxable year; and

(2) where a bad debt, prior tax, or delinquency amount was not allowable as a deduction or credit for the prior taxable year for purposes of this subtitle other than of section 531 or section 541 but was allowable for the same taxable year under section 531 or section 541, then a recovery exclusion shall be allowable if such bad debt, prior tax, or delinquency amount did not result in a reduction of the tax under section 531 or the tax under section 541.

INTERNAL REVENUE CODE, SECTION 164(e):

(e) *Taxes of Shareholder Paid by Corporation.*—Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation, then—

(1) the deduction allowed by subsection (a) shall be allowed to the corporation; and

(2) no deduction shall be allowed the shareholder for such tax.

ILL. REV. STAT., 1971, CH. 120, PARS. 557, 558 and 676.01:

557. *Listing and valuing stock of State and National Banks.*

Sec. 76. The stockholders of every kind of incorporated bank located within this State, whether such bank has been organized under the banking law of this State, or of the United States, shall be assessed and taxed upon the value of their shares of stock therein, in the taxing district where such bank or banking association is located and not elsewhere, whether such stockholders reside in such place or not. The value of such shares of stock for purposes of taxation shall be ascertained by deducting from the value of all the shares of the capital stock of such bank the fair cash value of the real estate owned by such bank or banking association situated in the county in which such bank or banking association is located, as determined by the assessor. Such shares shall be listed and assessed with regard to the ownership and value thereof as they existed on the first day of April annually, subject, however, to the restriction that taxation of such shares shall not be at a greater rate than is assessed upon any other moneyed capital in the hands of individual citizens of this State, in the taxing district where such bank is located. The shares held in this State of capital stock of National banks not located in this State shall not be required to be listed under the provisions of this Act.

558. *Assessment of bank shares and collection of tax.* Sec. 77. In each such bank there shall be kept at all times a full and correct list of the names and residences of its stockholders, and of the number of shares held by each; which list shall be subject to the inspection of the officers authorized to assess property for taxation; and it shall be the duty of the assessor to ascertain and report to the county clerk a correct list of the names and residences of all stockholders in any such bank, with the number and assessed value of all such shares held by each stockholder.

The county clerk, to whom such returns are made, shall enter the valuation of such shares in the tax lists, in the names of the respective owners of the same, and shall compute and extend taxes thereon the same as against the valuation of other property in the same locality.

The collector of taxes, and the officer or officers authorized to receive taxes from the collector, may, all or any of them, have an action to collect the tax assessed on any share or shares of bank stock from the avails of the sale of such share or shares; and the tax against such share or shares shall be and remain a lien thereon until the payment of said tax.

For the purpose of collecting such taxes, it shall be the duty of every such bank, or the managing officer or officers thereof, to retain so much of any dividend or dividends belonging to such stockholders as shall be necessary to pay any taxes levied upon their shares of stock, respectively, until it shall be made to appear to such bank or its officers that such taxes have been paid, and any officer of any such bank who shall pay over or authorize the paying over of any such dividend or dividends, or any portion thereof, contrary to the provisions of this section, shall thereby become liable for such tax; and if the said tax shall not be paid, the collector of taxes where said bank is located shall sell said share or shares to pay the same, like other personal property. And in case of sale the provision of law in regard to the transfer of stock when sold on execution shall apply to such sale.

676.01. *Deposit of payments of personal property taxes extended in 1972—Payment under protest presumed.* Sec. 195.01. The County collector of each county shall deposit in a special interest-bearing escrow account an amount equal to all payments of ad valorem personal property taxes extended in 1972 against personal property owned by a natural person, or two or more natural persons as joint tenants or tenants in common, and received by him pending final disposition of *Lake Shore Auto Parts v. Korzen*, 49 Ill. 2d 137 (1971). All such payments shall be considered to have been made under protest. Each taxpayer for whom such tax payments are placed in escrow shall be eligible for automatic full repayment from the county collector if such personal property taxes are ultimately held to be invalid, the provisions of Sections 194 and 195 of this Act notwithstanding. No part of the funds deposited in the

escrow account may be withdrawn except by the county collector subsequent to final disposition of *Lake Shore Auto Parts v. Korzen*.

TREASURY REGULATIONS, SECTION 1.111-1(a)(2):

(2) *Definition of "recovery"*. Recoveries result from the receipt of amounts in respect of the previously deducted or credited section 111 items, such as from the collection or sale of a bad debt, refund or credit of taxes paid, or cancellation of taxes accrued. Care should be taken in the case of bad debts which were treated as only partially worthless in prior years to distinguish between the item described in section 111, that is, the part of such debt which was deducted, and the part not previously deducted, which is not a section 111 item and is considered the first part collected. The collection of the part not deducted is not considered a "recovery". Furthermore, the term "recovery" does not include the gain resulting from the receipt of an amount on account of a section 111 item which, together with previous such receipts, exceeds the deduction or credit previously allowed for such item. For instance, a $100 corporate bond purchased for $40 and later deducted as worthless is subsequently collected to the extent of $50. The $10 gain (excess of $50 collection over $40 cost) is not a recovery of a section 111 item. Such gain is in no case excluded from gross income under section 111, regardless of whether the $40 recovery is or is not excluded.

Respondent's Brief

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Nos. 81-485 and 81-930

In the Supreme Court of the United States

OCTOBER TERM, 1981

HILLSBORO NATIONAL BANK, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

UNITED STATES OF AMERICA, PETITIONER

v.

BLISS DAIRY, INC.

ON WRITS OF CERTIORARI
TO THE UNITED STATES COURTS OF APPEALS
FOR THE SEVENTH AND NINTH CIRCUITS

BRIEF FOR THE COMMISSIONER IN NO. 81-485 AND THE UNITED STATES IN NO. 81-930

REX E. LEE
Solicitor General

GLENN L. ARCHER, JR.
Assistant Attorney General

STUART A. SMITH
Assistant to the Solicitor General

GARY R. ALLEN
JAY W. MILLER
DAVID I. PINCUS
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 633-2217

QUESTIONS PRESENTED

No. 81-485. Whether the tax benefit rule required a bank to include in gross income the amount of a state tax that it had paid in a previous taxable year on behalf of its stockholders, and for which it had taken a federal income tax deduction, when it was subsequently determined that the state tax was not owing and the tax was refunded directly to the bank's stockholders in the taxable year at issue.

No. 81-930. Whether the tax benefit rule required a liquidating corporation to include in gross income for the year of its liquidation, an amount equal to the value of unconsumed cattle feed it distributed to its shareholders, where the corporation had previously deducted the cost of that feed in full, and where the shareholders acquired a "stepped-up" basis in the feed enabling them to claim a further deduction for the feed when it was consumed during their subsequent operation of the business in non-corporate form.

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In the Supreme Court of the United States

OCTOBER TERM, 1981

No. 81-485

HILLSBORO NATIONAL BANK, PETITIONER

v.

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OPINIONS BELOW

No. 81-485. The opinion of the Tax Court (H. Pet. App. A-21 to A-48)[1] is reported at 73 T.C. 61. The opinion of the court of appeals (H. Pet. App. A-1 to A-20) is reported at 641 F.2d 529.

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[1] "H. Pet. App." references are to the appendix to the petition in the *Hillsboro National Bank* case, and "B. Pet. App." references are to the appendix to the petition in the *Bliss Dairy* case. Pursuant to the Court's order of March 1, 1982, no joint appendix has been filed in these cases.

No. 81-930. The opinion of the district court (B. Pet. App. 1a) is not reported. The opinion of the court of appeals (B. Pet. App. 2a-5a) is reported at 645 F.2d 19.

JURISDICTION

No. 81-485. The judgment of the court of appeals was entered on February 25, 1981 (H. Pet. App. A-47 to A-48). A petition for rehearing and rehearing en banc was denied on June 9, 1981 (H. Pet. App. A-49 to A-50). The petition for a writ of certiorari was filed on September 5, 1981, and granted on January 18, 1982. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

No. 81-930. The judgment of the court of appeals was entered on May 11, 1981 (B. Pet. App. 6a). The government's petition for rehearing was denied on July 31, 1981 (B. Pet. App. 7a). On October 2, 1981, Justice Rehnquist extended the time within which the government could file a petition for a writ of certiorari to November 21, 1981. The petition was filed on November 16, 1981, and granted on January 18, 1982. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

STATUTES AND REGULATION INVOLVED

The relevant provisions of Sections 164, 332, 333, 334, 336 and 337 of the Internal Revenue Code of 1954 (26 U.S.C. (& Supp. III)), and Section 1.164-7 of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.), are set forth in the Appendix, *infra*, 1a-4a.

STATEMENT

No. 81-485. Petitioner Hillsboro National Bank is a national banking association with its principal place of business in Hillsboro, Illinois. Prior to 1971, the stockholders of incorporated banks located within Illinois were subject to a personal property tax on the value of their shares. Ill. Ann. Stat. ch. 120, § 557 (Smith-Hurd 1970). The banks, however, were themselves required to retain dividends sufficient to pay those taxes. Ill. Ann. Stat. ch. 120, § 558 (Smith-Hurd 1970). Rather than retain-

ing dividends, Illinois banks customarily paid the taxes on behalf of their stockholders (H. Pet. App. A-2, A-23 to A-24).

In 1970, Illinois amended its constitution, effective January 1, 1971, to prohibit ad valorem taxation on personal property owned by individuals. In July 1971, however, the Illinois Supreme Court held the amendment invalid on the ground that it violated the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution. *Lake Shore Auto Parts Co.* v. *Korzen*, 49 Ill. 2d 137, 273 N.E.2d 592 (1971). After this Court granted certiorari in that case (405 U.S. 1039), Illinois enacted a statute directing that the disputed property taxes be deposited in an interest-bearing escrow account pending final resolution of the *Lake Shore* case, and further providing that full repayment would be made to the taxpayers "for whom such tax payments are placed in escrow" if the taxes were "ultimately held to be invalid" (Ill. Ann. Stat. ch. 120, § 676.01 (Smith-Hurd Cum. Supp. 1981)) (H. Pet. App. A-3, A-26 to A-27).

On July 7, 1972, Hillsboro Bank paid $26,110.32 to the County Collector of Montgomery County, Illinois, in satisfaction of the 1971 personal property taxes owed by its individual stockholders on their bank shares. On its 1972 tax return, the Bank claimed a deduction for these tax payments pursuant to Section 164(e) of the Internal Revenue Code of 1954 (26 U.S.C.) (H. Pet. App. A-3, A-4, A-23 to A25).[2]

In February 1973, this Court reversed the Illinois Supreme Court, holding that the Illinois constitutional amendment prohibiting the imposition of such taxes was valid. *Lehnhausen* v. *Lake Shore Auto Parts Co.*, 410

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[2] Section 164(e) provides that where a corporation pays a tax imposed on a shareholder on his interest as a shareholder and is not reimbursed for such payment, the corporation (and not the shareholder) is allowed the deduction for the tax provided for by Section 164(a). Such payment is not then included in the shareholder's gross income. Treas. Reg. § 1.164-7 (26 C.F.R.).

U.S. 356. Acting upon the advice of the Illinois States Attorney and the Illinois Department of Local Government Affairs, the County Treasury of Montgomery County, Illinois, thereupon refunded $26,697.79 (representing the $26,110.32 in erroneously collected personal property taxes, plus $587.47 in accrued interest) directly to the Bank's individual stockholders. The Bank did not include any portion of the refunded amount in gross income as reported on its return for its taxable year ended December 31, 1973 (H. Pet. App. A-27 to A-29).

On audit, the Commissioner of Internal Revenue determined that the entire sum refunded to the shareholders was includible in the Bank's gross income for 1973 under the tax benefit rule because the tax refund in 1973 was inconsistent with the Bank's claimed deduction of the state tax in 1972. In this proceeding brought by the Bank for redetermination of the Commissioner's deficiency, the Tax Court ruled that the amount previously deducted (but not the accrued interest) was properly included in the Bank's income for 1973 under the tax benefit rule. The Court reasoned that otherwise the Bank would be able to retain the benefit of a deduction for what was, in ultimate effect, a dividend distribution (H. Pet. App. A-21 to A-46).

The court of appeals affirmed, with one judge dissenting (H. Pet. App. A-1 to A-20). Adhering to its earlier decision in *First Trust and Savings Bank* v. *United States*, 614 F.2d 1142 (7th Cir. 1980), in which it had applied the tax benefit rule in almost identical circumstances, the court held that the tax benefit rule should be applied where "there is either an actual recovery of a previously deducted amount or some other event inconsistent with the prior deduction" (H. Pet. App. A-7). It concluded that the latter ground "applies foursquare in this case" because the state tax refund had "transformed a tax payment deductible under Sec. 164(e) into a nondeductible cash dividend to the Bank's stockholders" (H. Pet. App. A-8).

No. 81-930. Respondent Bliss Dairy, Inc. was a closely held Arizona corporation engaged in the business of operating a dairy. It kept its books and filed its income tax returns using a cash method of accounting, with a fiscal and taxable year beginning on July 1 and ending June 30. During its taxable year ending June 30, 1973, Bliss purchased $150,199 worth of cattle feed for use in its dairy operations. In accordance with its cash method of accounting, it deducted the full cost of the feed from its gross income as a business expense on its 1973 return, even though a substantial portion of the feed had not yet been consumed by the end of that year (B. Pet. App. 2a-3a).

On July 2, 1973, two days into the following taxable year, Bliss adopted a plan of liquidation pursuant to Section 333 of the Internal Revenue Code of 1954.[3] In accordance with that plan, Bliss, during the month of July 1973, distributed all of its assets pro rata to its shareholders, who thereafter continued to operate the dairy business in non-corporate form. Among the assets so distributed was the unconsumed cattle feed that Bliss deducted as an expense for the preceding taxable year. That feed had an adjusted basis in the hands of the corporation of zero because it had previously deducted the full cost of the feed. As a result of the liquidation, however, the shareholders acquired "stepped-up" tax bases in the feed, thereby allowing them the benefit of further deductions on their individual tax returns for the period in which the feed was actually consumed (B. Pet. App. 3a).[4]

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[3] Under Section 333, shareholders receiving corporate assets pursuant to a qualifying one-month liquidation are required to recognize only so much of their gain as does not exceed the greater of their pro rata share of the corporation's earnings and profits or the amount of money and (post-1953) stock and securities received in the liquidation.

[4] Under Section 334(c) of the Code, a shareholder's basis in property acquired in a Section 333 liquidation is equal to the basis he had in the liquidating corporation's stock, decreased by the

On audit of Bliss' federal income tax return for its final taxable year (July 1, 1973 through July 31, 1973), the Commissioner of Internal Revenue increased Bliss' gross income by $60,000, representing his determination of the value of the unconsumed feed that Bliss distributed to its shareholders.[5] Bliss paid the resulting assessment and brought this refund suit in the United States District Court for the District of Arizona. Although the district court agreed that the Commissioner's determination was correct, it considered itself bound by the Ninth Circuit's prior decision in *Commissioner* v. *South Lake Farms, Inc.*, 324 F.2d 837 (1963), and stated that it would follow that case "until such time as it is overruled" (B. Pet. App. 1a).

The court of appeals affirmed on the authority of its prior decision in *South Lake Farms*. There, it had declined to apply the tax benefit rule in comparable circumstances involving the liquidation of a subsidiary corporation into its parent under Section 332 of the Code. In adhering to its decision in *South Lake Farms*, the court of appeals acknowledged that "[r]ecent decisions in the Courts of Appeals of other circuits are in conflict with our holding in *South Lake Farms*" (B. Pet. App. 4a).[6]

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amount of money received in the liquidation, and increased by the amount of any gain recognized. Where several assets are received, the shareholder apportions his total basis among these assets in accordance with their relative fair market values. Treas. Reg. § 1.334-2 (26 C.F.R.). The record does not disclose the exact amount of basis that the Bliss shareholders assigned to the unused cattle feed distributed by the corporation. However, the parties stipulated in the district court that the shareholders, on their 1973 individual income tax returns, claimed deductions attributable to the feed they received in the liquidation (see B. Pet. App. 3a).

[5] It was later stipulated that at the time of distribution, the unconsumed feed had a value of $56,565 (B. Pet. App. 3a).

[6] See *Tennessee-Carolina Transportation, Inc.* v. *Commissioner*, 65 T.C. 440 (1975), aff'd, 582 F.2d 378 (6th Cir. 1978), cert. denied, 440 U.S. 909 (1979); *First Trust and Savings Bank* v. *United States*, 614 F.2d 1142 (7th Cir. 1980); *Hillsboro National Bank* v. *Commissioner*, 641 F.2d 529 (7th Cir. 1981), cert. granted, No. 81-485 (Jan. 18, 1982).

SUMMARY OF ARGUMENT

I

A. One of the fundamental principles upon which the federal income tax is based is the annual accounting system, which draws arbitrary lines between taxable periods. In so doing, the annual accounting system necessarily rejects a transactional approach under which tax consequences await the completion of each particular transaction, rather than the close of a taxable period. The firm lines of demarcation between taxable periods will inevitably produce situations in which the taxpayer may be required to report income or may be entitled to claim deductions for a particular year even though events occurring in a subsequent year may affect the amount of income actually enjoyed or the outlays or losses ultimately incurred. The proper remedy for taking account of such changed circumstances is not to amend or modify the original return, but rather to reflect the change on the return covering the later period during which the offsetting events actually occurred. See, *e.g.*, *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931); *Healy* v. *Commissioner*, 345 U.S. 278 (1953).

In response to the requirements of the annual accounting system, the courts have developed the "tax benefit rule" to deal with such subsequent year reportings. The rule is designed to ensure a measure of tax parity in the effect of an earlier deduction and later correcting entry. Under the tax benefit rule, the required correction for expenses that are deducted but not ultimately incurred is for income in the later year to be increased by the amount of the prior deduction.

The tax benefit rule at issue in these cases requires the restoration of a prior year's deduction to income when subsequent events establish the invalidity of the factual premise on which the prior year's deduction was claimed. In *Hillsboro National Bank*, the taxpayer-bank paid certain state personal property taxes on behalf of its shareholders and claimed a deduction for those taxes

in 1972. After it was determined that the taxes were not due and owing, the State refunded the taxes directly to the shareholders in 1973. In *Bliss Dairy*, the taxpayer-corporation purchased cattle feed for use in its business. In accordance with an accounting convention, it deducted the full cost of the feed as a business expense. In the following tax year, however, the corporation liquidated and distributed unconsumed cattle feed for which it had previously taken a deduction. These after-arising inconsistent events—the refund of the state taxes and the distribution of the unconsumed feed—eliminate the factual premises upon which the taxpayers claimed the prior years' deductions. If a state tax turns out not to be due, there is no justification for the bank's retaining the benefits of a deduction premised on its payment. And if cattle feed will not be used in a corporation's business, the corporation must restore the deduction to its income when the fact of non-consumption by the corporation becomes apparent. In sum, the subsequent events in both cases demonstrate that the taxpayers were not entitled to the deductions that they originally claimed.

B. The taxpayers here acknowledge the existence of the tax benefit rule but resist its application in these cases on the ground that they did not enjoy an actual recovery of money or property. Thus, Hillsboro Bank argues that it should not be required to restore its deduction for state taxes to income because the state tax refund was paid to its shareholders, rather than to itself. Likewise, Bliss Dairy contends that the deduction for unconsumed cattle feed should not be restored to income because it received nothing when it distributed the feed to its shareholders upon liquidation.

But both taxpayers misjudge the purpose of the tax benefit rule. That rule does not depend upon an actual recovery of money or property. The early cases that developed the tax benefit rule did not turn upon the identification and taxation of economic benefits that could be considered to be actual current taxable income.

Rather, the courts recognized that the tax benefit rule is a remedial device designed to assure that a taxpayer's income over a period encompassing several taxable years is accurately reflected where subsequent events establish that no loss or expenses will actually be incurred. For example, an early case required, on tax benefit principles, a taxpayer to restore to income a previously claimed depletion deduction taken in anticipation of exhaustion of her property's oil reserve when the lease she had granted expired without any production ever having taken place. *Barnett* v. *Commissioner*, 39 B.T.A. 864 (1939).[7] There, it is plain that no "actual recovery" of money or property occurred. The taxpayer had to recognize income in the current year not because she actually received anything that might be characterized as income in the current year for she plainly had not. Rather, income recognition was necessary to balance out the prior deduction that was allowed in anticipation of events that did not ultimately occur. As the Board of Tax Appeals stated, "[w]hen some event occurs which is inconsistent with a deduction taken in a prior year, adjustment may have to be made by reporting a balancing item in income for the year in which the change occurs" (39 B.T.A. at 867).

Hence, the tax benefit rule is a mechanism for putting right the imbalance caused by a change in circumstances undermining the premise on which previously claimed deductions were based. Thus, the taxpayers in these cases are treated as realizing income only because they deducted amounts that prove to have exceeded their actual loss or cost. Since the basis of the tax benefit rule is the need to correct the income distortion caused by a taxpayer's having claimed a deduction which, in light of hindsight, exceeded his actual expenses, it follows that the rule should apply on the occurrence of any event that refutes the correctness of the factual assumptions under-

[7] This Court subsequently reached the same result in *Douglas* v. *Commissioner*, 322 U.S. 275, 284-287 (1944).

lying a previously claimed deduction. Although an actual recovery is the usual type of event that triggers application of the tax benefit rule, the cases establish that such recovery is not the only type of event that requires restoration of a prior year's deduction.

II

Viewed from this perspective, it is plain that Hillsboro Bank must restore its prior deduction for state taxes to its income, even if it is not deemed to have received an actual recovery of money or property. Here, the refund of the amounts previously paid on behalf of the Bank's shareholders for satisfaction of the personal property tax liability negates the factual premise upon which the Bank previously deducted such amounts pursuant to Sections 164(e) and 461(f) of the Code. In enacting the latter provision permitting the current deduction of contested liabilities, Congress explicitly stated its understanding that any "overstatement of the deduction" would be restored to income "in the year in which the liability is finally determined" S. Rep. No. 830, 88th Cong., 2d Sess. 100 (1964). Hence, the tax benefit principle was ratified by Congress as applicable to the circumstances here.

The fact that the refund was paid directly to the shareholders, rather than to the Bank alone, or to the Bank and its shareholders jointly, is not a sufficient basis for allowing the Bank the continuing benefit of its prior deduction. The particular identity of the recipient of the refund is of no moment. For purposes of the tax benefit rule, the critical fact is that the determination of nonliability and the consequent tax refund (whether to the Bank or to its shareholders) are events that are inconsistent with, and eliminate the justification for, the allowance of a deduction to any party under Section 164. Indeed, as the court below recognized (H. Pet. App. A-8), the ultimate result was to transform the escrow deposit into a dividend from the Bank to the shareholders. Thus, unless the tax benefit rule applies to restore the prior deduction

to the Bank's income, the Bank will obtain the wholly improper benefit of a tax deduction for a dividend distribution to its shareholders. The corrective tax benefit rule is designed to prevent such an anomaly.[8]

III

The corrective tax benefit rule likewise applies to Bliss Dairy. On its return for its taxable year ending June 30, 1973, Bliss Dairy deducted the full cost of $150,199 worth of cattle feed that it had purchased in that year. This deduction was based on the assumption that the feed would ordinarily be consumed within a relatively short time in the course of the operation of its business. However, only $93,634 of the feed was consumed in the year for which the deduction was claimed. On the second day of the next taxable year, Bliss Dairy liquidated and distributed the remaining $56,565 worth of previously-deducted feed to its shareholders. This distribution in kind of unconsumed feed eliminated the basis for the original assumption underlying Bliss Dairy's earlier deduction, *i.e.*, that the feed would be consumed in the ordinary course of its business. If Bliss Dairy had used the feed for its shareholders' personally-owned cattle, the deduction would be restored to its income. Accordingly, Bliss Dairy's liquidating transfer of the feed was likewise an appropriate event for applying the tax benefit rule to require a restoration of the amount deducted for the distributed feed in the prior year.

Indeed, the case for application of the tax benefit rule is considerably enhanced by the fact that absent restora-

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[8] Moreover, even if some form of recovery is deemed to be necessary to invoke the tax benefit rule, we submit that the Bank constructively recovered the refunded taxes. Indeed, that is precisely what the Tax Court determined in this case, stating that "When in 1973 [Section 164(e)] was retroactively determined not to apply, and the taxes paid were refunded to these same shareholders, [the Bank] must be deemed to have received back its payments from the State and itself paid these amounts out to its shareholders" (H. Pet. App. A-39).

tion of the deduction, there will be a double deduction for the same cattle feed. As this Court reaffirmed in *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 684 (1969), "the Code should not be interpreted to allow * * * 'the practical equivalent of double deduction' * * *, absent a clear declaration of intent by Congress." But unless the tax benefit rule applies in this case, the result would not simply be "the practical equivalent" of a double deduction but a double deduction in fact. Here, the shareholders of Bliss Dairy who continued its business in noncorporate form took a "stepped-up" basis in the cattle feed computed by reference to the basis of their stock in the corporation under Section 334(c) of the Code. They quite properly deducted the amount of that basis when the feed was consumed in the course of their business. In a prior year, however, Bliss Dairy claimed a similar deduction for the cost of the feed. In these circumstances, Bliss Dairy must restore to its own income the amount previously deducted for that portion of the feed that was not ultimately used in its trade or business but rather in the trade or business of its shareholders.

Commissioner v. *South Lake Farms, Inc.*, 324 F.2d 837 (9th Cir. 1963), upon which the decision below relied, is not cogent authority for the proposition that the tax benefit rule requires a recovery of money or property. There, in a prior decision the court of appeals stated that "[n]owhere in the Code do we find an intent that gains to the stockholders were to be attributed to the corporation, much less that they were to be treated as ordinary income to the corporation" (324 F.2d at 389). But the court below misunderstood why Bliss Dairy should be required to recognize income in the current taxable year. The government is not seeking to attribute to Bliss Dairy the gains of its shareholders. Rather it is Bliss Dairy's own ordinary income that the government seeks to restore to taxable income—*i.e.*, the income that escaped tax in the prior taxable year as a result of the deduction for cattle feed that would be consumed only in subsequent

periods. Once subsequent events made it clear that the anticipated event on which the deduction was based would not occur, such a restoration to income is required under the tax benefit rule.[9]

ARGUMENT

I

THE TAX BENEFIT RULE REQUIRES A TAXPAYER TO RESTORE TO INCOME PREVIOUSLY DEDUCTED ITEMS ONCE SUBSEQUENT EVENTS ESTABLISH THE INVALIDITY OF THE FACTUAL PREMISE UPON WHICH THE PRIOR YEAR'S DEDUCTION WAS CLAIMED, WHETHER OR NOT THE TAXPAYER ACTUALLY RECOVERS MONEY OR PROPERTY

A. The Tax Benefit Rule Is A Necessary Element Of The Annual Accounting System

1. A fundamental principle upon which the federal income tax is based is the annual accounting system. See Section 441 of the Internal Revenue Code of 1954. As the Court stated in *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931), "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation."

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[9] At all events, even on the assumption that an "actual recovery" is required to support an application of the tax benefit rule, Bliss Dairy had all the benefits of such a recovery from its distribution of the unconsumed cattle feed to its shareholders. For tax purposes, once the cost of materials are deducted, they are regarded as completely consumed. They are assigned a zero basis and are actually treated nonexistent for tax purposes. When, however, the value of the property becomes available for distribution to shareholders for their own sale or use, there is a "recovery" for tax purposes of the value that had been previously converted into an item of expense.

Second, Bliss Dairy's receipt of its stock certificates from its shareholders in the course of its liquidation constituted a recovery of the unconsumed cattle feed. At the time Bliss Dairy received its

The annual accounting system draws arbitrary lines between taxable periods. In so doing, it necessarily rejects a transactional approach under which tax consequences await the completion of each particular transaction, rather than the close of a taxable period. Accordingly, "[i]t is settled that each 'taxable year' must be treated as a separate unit, and all items of gross income and deduction must be reflected in terms of their posture at the close of such year." *United States* v. *Consolidated Edison Co.*, 366 U.S. 380, 384 (1961). The firm demarcations between taxable periods necessarily produce situations in which the taxpayer may be required to report income or may be entitled to claim deductions for a particular year even though events occurring in a subsequent year may affect the amount of income actually enjoyed or the liabilities or losses ultimately incurred.

Since this Court's decision in *Burnet* v. *Sanford & Brooks Co.*, *supra*, it has been established that the proper adjustment for such changed circumstances is not to be made in the year in which the item of income was originally reported or the deduction claimed, but rather by means of a corrective entry for the year in which the change of circumstance occurs. For example, in *North American Oil* v. *Burnet*, 286 U.S. 417 (1932), this Court held that when a taxpayer receives income in one year under a "claim of right," that amount is includable in gross income for the year of receipt, even though the taxpayer is divested of the income in a subsequent year. *North American Oil* made equally clear that the subsequent divestment of such an item of income would give rise to a deduction in the subsequent year. As the Court there explained, "[i]f in 1922 the Government had prevailed, and the company had been obliged to refund the

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shares back from its shareholders in the course of liquidation, those shares still had value reflecting the $56,565 in unconsumed cattle feed remaining on hand. Thus, there was a "recovery" of the value of that feed. Thus, an actual recovery occurred when Bliss Dairy exchanged its assets for shares that had an equivalent value at the time of the transfer.

profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year * * *" (*id.* at 424). See also *United States* v. *Lewis*, 340 U.S. 590 (1951); *Healy* v. *Commissioner*, 345 U.S. 278 (1953); *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 680-681 (1969). See generally 1 B. Bittker, *Federal Taxation of Income, Estates and Gifts*, ¶¶ 6.3.1 through 6.3.4 (1981).[10]

The tax benefit rule involved in these cases is the converse of the claim of right doctrine established by this Court in *North American Oil* and to which the Court adverted at the conclusion of its opinion in that case. For just as the claim of right doctrine requires the reporting of income based upon the circumstances known to exist at the end of the particular period, the tax benefit rule entitles a taxpayer to enjoy the benefit of whatever deductions appear to be proper based upon the circumstances that exist at the end of the taxable period. In both cases, however, subsequent events require corrective adjustments to be made in later years. Thus, when a taxpayer receives income subject to a claim of right and reports it in year 1, he may claim a deduction for year 2 if he must return or relinquish the item of

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[10] In *United States* v. *Lewis*, *supra*, the allowance of a later-year deduction for the repayment of previously reported income did not produce a tax benefit commensurate with the tax cost of reporting the item of income in the first instance. In response, Congress added Section 1341 to the statute, as part of the 1954 codification, in order to achieve a closer correspondence between the tax benefit of the later deduction and the tax cost of the earlier inclusion.

Section 1341 generally provides that if an item is included in income under a claim of right in one year and becomes deductible in a subsequent year because it was established that the taxpayer did not have an unrestricted right to the item, and the amount of the deduction exceeds $3,000, then the tax for the subsequent year is the lesser of: (a) the tax computed with the deduction; or (b) the tax for the taxable year computed without the deduction, minus the decrease in tax for the prior taxable year that would result from the exclusion of the item from gross income for the prior taxable year. The statute therefore insures that the tax benefit obtained will be the greater of the amount achieved either by deduction or exclusion.

income in that later year. Conversely, where a taxpayer obtains a tax benefit for a deduction claimed in year 1 and it is established in year 2 that the anticipated loss or expense for which the deduction is claimed will not be incurred, he must restore the deduction to income in year 2. See, generally, 1 B. Bittker, *supra*, ¶ 5.7.1.

As the tax benefit rule originally developed, it dealt primarily with the inclusion in gross income of previously deducted amounts such as debts that had been written off as worthless and that were later collected. See, *e.g.*, *Putnam National Bank* v. *Commissioner*, 50 F.2d 158 (5th Cir. 1931). Absent the prior deduction, there would of course be no occasion for classifying the collection of a debt as a taxable event. Hence, a controversy early arose as to whether full restoration to income of the previously deducted amount would be justified to the extent the deduction had not led to a "tax benefit" in the earlier year. That question, however, was put to rest in 1942 with the adoption of Section 22(b)(12) (Act of Oct. 21, 1942, ch. 619, 56 Stat. 812) of the Internal Revenue Code of 1939 (26 U.S.C. (1952 ed.)) (the predecessor to Section 111 of the 1954 Code), which specifically provided for the exclusion from income of subsequently recovered bad debts, prior taxes and "delinquency amounts" to the extent that prior credits or deductions did not give rise to an actual tax benefit.[11] See *Dobson* v. *Com-*

[11] Section 111 thus performs a function that is somewhat analogous (albeit with somewhat less precision) to Section 1341 in the context of the "claim of right" doctrine (see page 15, note 10). In *United States* v. *Skelly Oil Co.*, *supra*, where the special provisions of Section 1341(a)(5) did not apply, the Court adopted an analogue to this aspect of the tax benefit rule, holding that where the taxpayer had enjoyed the benefit of a depletion allowance measured by a percentage of previously reported income which it was thereafter required to give up, the amount of the subsequent deduction under *North American Oil* should be similarly reduced. In so holding the Court noted that the taxpayer would otherwise be allowed " 'the practical equivalent of a double deduction,' " a result the Court concluded should not be permitted "absent a clear declaration of intent by Congress" (394 U.S. at 684, quoting *Charles Ilfeld Co.* v. *Hernandez*, 292 U.S. 62, 68 (1934)).

missioner, 320 U.S. 489, 505 (1943). Indeed, while the "inclusionary" principles outlined above had already become firmly established by that time, the term "tax benefit rule" appears to have originated and to have been first applied in the context of the exclusionary principles ratified by the enactment of Section 22(b)(12), and the courts have, on occasion, continued to use the term solely in that context. See, *e.g.*, *Alice Phelan Sullivan Corp.* v. *United States*, 381 F.2d 399, 401-402 (Ct. Cl. 1967). In recent years, however, the term has come to be used to encompass both the exclusionary principle and the inclusionary principle that it presupposes. See, *e.g.*, *Nash* v. *United States*, 398 U.S. 1, 3 (1970); *Home Mutual Insurance Co.* v. *Commissioner*, 639 F.2d 333, 343 (7th Cir. 1980), cert. denied, 451 U.S. 1017 (1981); *Anders* v. *United States*, 462 F.2d 1147, 1149 (Ct. Cl.), cert. denied, 409 U.S. 1064 (1972); 1 B. Bittker, *supra*, ¶ 5.7.1.

It is in this broader sense that the term "tax benefit rule" is used in the present cases, which involve applications of the inclusionary aspect of the rule in different factual contexts. While neither Section 22(b)(12) nor its successor, Section 111 of the 1954 Code, expressly codified the "inclusionary" aspect of the rule, this enactment necessarily signals Congress' approval of the "inclusionary" principles applicable here. See *Continental Illinois National Bank & Trust Co.* v. *Commissioner*, 69 T.C. 357, 370 (1977); 1 B. Bittker, *supra*, ¶ 5.7.1, at 5-49.[12]

2. The inclusionary aspect of the tax benefit rule requires the restoration to income of a prior year's deduction when subsequent events establish the invalidity of the factual premise on which the prior year's deduc-

[12] Congress' approval of the "inclusionary" aspect of the tax benefit rule is also implied by its enactment of Section 461(f) of the Code, allowing the deduction of contested liabilities. As we discuss (pages 31-32, *infra*), Congress enacted this provision on the explicit understanding that a restoration to income would be required if the liability was ultimately set aside. See S. Rep. No. 830, 88th Cong., 2d Sess. 100 (1964).

tion was claimed. What is at issue in the present cases is whether the application of the tax benefit rule depends upon the actual physical recovery of money or property by the taxpayer, or whether the rule also requires restoration to income of a previously deducted expense when subsequent events eliminate the factual premise on which the deduction was originally claimed.

We submit that the latter proposition is the correct rule. In *Hillsboro Bank*, the pertinent event was the judicial determination that the previously deducted state tax was not due and owing and the refund of those tax payments to the Bank's shareholders. Likewise, in *Bliss Dairy*, the relevant event was the liquidation of the corporation and its distribution of unconsumed cattle feed to its shareholders, thereby establishing that the cattle feed would not be consumed in its business. If a state tax turns out not to be due, there is no basis for continued enjoyment of a deduction premised on its payment and the bank must restore the deduction to income. And if cattle feed will not be used in a corporation's business, that corporation must restore the deduction to its income when the fact of non-consumption by the corporation becomes established. In sum, the subsequent events in both cases demonstrate that the taxpayers did not incur the expense for which they previously claimed the deductions.

3. Perhaps the most common application of the tax benefit rule arises in the context of the deduction for state income taxes permitted by Section 164 of the Code. Suppose A, a salaried employee who reports his income on the cash basis method of accounting, has $2,000 of state income taxes withheld from his salary during 1980. When he files his 1980 state income tax return on April 15, 1981, he discovers that his state tax liability is only $1,500, so that he is entitled to a $500 refund, which the state department of revenue pays to him in June 1981. As a cash basis taxpayer, A is entitled to claim the $2,000 in taxes as an itemized deduction on his 1980 federal return, since that amount was fully paid by withholding during 1980. However, because the deduc-

tion produced a tax benefit in 1980, A must include the $500 refund in his 1981 federal taxable income. Indeed, the frequency of this situation has led the Internal Revenue Service to add a line entitled "Refunds of state and local income taxes" (Line 9) on the Form 1040 individual income tax return so as to increase compliance with the tax benefit rule.

The parties would apparently agree that the foregoing example offers an appropriate case for the application of the rule. They disagree, however, as to the critical element upon which the tax benefit rule rests. The taxpayers in these cases urge that the sine qua non for the application of the rule is the actual recovery of money or property, *i.e.*, the receipt of the state tax refund. In *Hillsboro Bank*, the taxpayer asserts that the payment of the tax refunds to its shareholders (rather than to itself) renders the tax benefit rule inapplicable. In *Bliss Dairy*, the taxpayer claims that it never received any recovery warranting application of the rule.

But surely the actual receipt of the tax refund is not the critical element necessary to support the application of the tax benefit rule. Returning to our example, if A had claimed the standard deduction in 1980 or had a tax loss for that year without taking the state tax deduction into account, his actual receipt of the $500 state tax refund would not have been includable in his 1981 gross income. Conversely, if A had claimed an itemized deduction for the state taxes and therefore enjoyed a tax benefit on his 1980 return, but the state required him to credit the $500 refund to his (or his wife's separate) 1981 state tax liability, the tax benefit rule would nevertheless require the inclusion of the $500 refund in his 1981 federal gross income. Properly analyzed, the $500 refund would have been deemed to have been paid to A, who then would be deemed to have paid it either back over to the state, or to his wife, who then would have been deemed to have paid it back to the state. In the same manner, Hillsboro Bank must be deemed to have received back the tax refund and paid it over to its share-

holders. Hence, actual receipt or recovery of the money or property disbursed in connection with the prior year's deduction is not a requirement of the tax benefit rule.

We submit that there are two essential elements for the application of the inclusionary aspect of the tax benefit rule at issue in these cases. First, the prior year's deduction must produce a tax savings or benefit. That element is indisputably present in both of these cases. Both Hillsboro Bank and Bliss Dairy enjoyed a tax benefit from their deductions of state taxes and cattle feed purchases. Second, an event must occur in the tax year at issue which eliminates the factual premise upon which the deduction was originally claimed. This event could well take the form of an actual recovery of money or property, as in the first variation of our example. The $500 tax refund to the taxpayer removes the factual premise upon which the $2,000 deduction for taxes was based and requires a corrective adjustment of $500 for the year that the refund was paid. But the event that removes the factual premise of the prior deduction (in part or in whole) need not take the form of an actual physical recovery of money or property. It could, as we suggest, take the form of a required issuance of a $500 credit to A's (or his wife's) 1981 state tax liability. The factual premise underlying the original deduction would nevertheless be refuted, requiring restoration of the prior year's deduction into income.

There are many other instances in which the subsequent event that undermines the foundation of the prior year's deduction and triggers the application of the tax benefit rule does not involve any recovery at all. In our view, the triggering event can be any after-arising circumstance that demonstrates the invalidity of the factual premise on which the prior deduction was originally claimed. It is this so-called "inconsistent event" that lies at the heart of the tax benefit rule and requires a corrective adjustment to set matters right. If, for example, the events at issue here had occurred during the selfsame prior year in which the deductions were taken, there is no doubt that neither Hillsboro Bank or Bliss

Dairy would have been entitled to claim their deductions for state taxes and cattle feed. When such "inconsistent" events occur in a subsequent taxable year, they remove the factual premise of the prior year's deductions. The tax benefit rule thereby requires restoration of those deductions to income.

B. The Courts Developed The Tax Benefit Rule In Order To Offset The Benefit Of A Deduction For Expenses Or Losses Which Subsequent Events Establish Will Not Be Incurred

1. The earliest origins of the principles underlying the tax benefit rule are found in the Treasury Regulations under the Revenue Act of 1913. Treasury Regulations 33, Art. 125 (1914) required the inclusion in income of collections on debts for which bad debt deductions had previously been taken. That regulation itself assumed an actual receipt of the previously deducted amount. But such a recovery, standing alone, would not be includable in the taxpayer's gross income insofar as the repayment of a loan is not ordinarily "income" within the meaning of the Sixteenth Amendment or the taxing statute. See *Alice Phelan Sullivan Corp.* v. *United States*, *supra*, 831 F.2d at 401; 1 B. Bittker, *supra*, ¶ 5.7.1 Rather, the recovery was simply an occasion for requiring a restoration to income of a previously deducted amount based on the fact that retention of the "tax benefit" generated by that deduction could no longer be justified.

The early case law makes much the same point in extending the tax benefit rule to the repayment of any amount for which a tax loss had previously been claimed. For example, in *South Dakota Concrete Products Co.* v. *Commissioner*, 26 B.T.A. 1429 (1932), the Board of Tax Appeals applied tax benefit principles to the recovery of embezzled amounts for which a loss deduction had been taken in a prior year, explaining that the basic justification for the rule was the necessity of accurately reflecting the taxpayer's income over a multi-year period. As the Board stated (26 B.T.A. at 1431): "The Commissioner has added no more to income than has been de-

ducted previously, thus bringing the amount of income reported over the period in balance with the actual income of the taxpayer for this period." The Board noted that the original deductions were simply "practical necessities due to our inability to read the future, and the inclusion of the recovery in income is necessary to offset the deduction" (*id.* at 1432).[13]

While the facts of *South Dakota Concrete* involved an actual recovery, the "balancing entry" theory adopted by the Board was not limited to the particular circumstances of that case. On the contrary, as the Board there indicated, the theory would apply whenever "an adjustment occurs which is inconsistent with what has been done in the past in the determination of tax liability" (26 B.T.A. at 1432). That such an "adjustment" might be required in a case involving other than an "actual recovery" is illustrated by the Board's subsequent decision in *Barnett* v. *Commissioner*, 39 B.T.A. 864 (1939). There, the Board upheld Treasury Regulations that required the taxpayer to restore to income a previously claimed depletion deduction taken in anticipation of exhaustion of her property's oil reserve when the lease she had granted to an oil company expired without any production ever having taken place. This Court subsequently reached the same result.[14] The significance of *Barnett* and its progeny is

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[13] Cf. *Home Mutual Insurance Co.* v. *Commissioner*, 639 F.2d 333, 344 (7th Cir. 1980), cert. denied, 451 U.S. 1017 (1981) (explaining that the tax benefit rule "allows accurate taxation of a whole transaction that may span several accounting periods," and permits "adjustments so that some transactions substantially altered in years subsequent to the original accounting period may be taxed virtually as though the entire transaction had occurred in one period").

[14] The requirement that oil depletion deductions be restored once it is clear that no mineral production will actually take place was approved in *Sneed* v. *Commissioner*, 119 F.2d 767 (5th Cir), cert. denied, 314 U.S. 686 (1941), in *Lamont* v. *Commissioner*, 120 F.2d 996 (8th Cir. 1941), and, ultimately, in *Douglas* v. *Commissioner*, 322 U.S. 275, 284-287 (1944), which cited all three prior decisions with approval. As the Eighth Circuit noted in *Lamont*, such a restoration does not "arbitrarily assume non-existent income" (120

that the Board relied on the tax benefit principle as authority for the Regulation. Thus, the Board reaffirmed its balancing entry theory advanced in *South Dakota Concrete* that the taxpayer had to recognize income in the current year not because she had actually received anything that might be characterized as income in the current year—for she plainly had not—but because income recognition was necessary to balance out the prior deduction that was allowed in anticipation of events that did not ultimately occur. As the Board noted (39 B.T.A. at 867) (emphasis added):

> [T]he present case is analogous to a number of others, where, with or without a supporting regulation, an adjustment has been made during the taxable year in which actually no income was received. * * * Income tax liability must be determined for annual periods on the basis of facts as they existed in each period. When some event occurs which is *inconsistent with a deduction taken in a prior year*, adjustment may have to be made by reporting a balancing item in income for the year in which the change occurs.

Accord: *G.M. Standifer Construction Corp.* v. *Commissioner*, 30 B.T.A. 184 (1934), appeal dismissed, 78 F.2d 285 (9th Cir. 1935).[15]

F.2d at 997). What is ultimately subjected to tax, as the court there emphasized, is the real income that escaped tax when the original depletion allowance was claimed. *Cf. United States* v. *Skelly Oil Co., supra*, 394 U.S. at 684, which similarly required corrective adjustment where the income, on which a depletion allowance was previously claimed, was required to be refunded.

[15] There, the Board required the taxpayer, in the year of its liquidation, to restore to income the amount of prior accrued deductions for wages that remained unpaid at that time. In holding that prior deductions for what amounted to a "reserve" for unpaid liabilities on a disputed claim should also have been restored to income, but only in the prior year when the dispute was settled for a lesser amount, the Board noted that "[t]he theory underlying the restoration of reserve balances to income, like that of recoveries on losses for prior years * * * and collections on debts previously de-

These early cases demonstrate that the application of the evolving principles that were ultimately comprehended as part of a broader "tax benefit rule" did not turn upon the identification and taxation of economic benefits that could be considered as actual current income. Rather, the courts recognized that the tax benefit rule was a remedial device designed to insure that a taxpayer's income over a period encompassing several taxable years would be accurately reflected where subsequent events establish that no loss or expenses will actually be incurred. Simply put, the tax benefit rule is a mechanism for putting right the imbalance caused by a previously claimed deduction that subsequent events prove to have exceeded the expense or loss actually incurred.[16]

2. To be sure, there have been more elaborate rationales suggested for the tax benefit rule. For example, in *National Bank of Commerce* v. *Commissioner*, 115 F.2d 875, 876-877 (9th Cir. 1940), the court suggested that the underlying theoretical basis of the tax benefit rule is

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ducted as worthless * * *, is that by taking the deductions in the earlier years the taxpayer benefited through a reduction of its taxable income, and subsequent events demonstrate that there was in fact no loss, even though honest belief so indicated at the time" (78 F.2d at 187).

[16] Legal scholars and commentators likewise agree that the purpose of the tax benefit rule is to rectify the distortion caused by a taxpayer's having taken a deduction to which, in the light of hindsight, he would not be entitled. See, *e.g.*, Plumb, *The Tax Benefit Rule Today*, 57 Harv. L. Rev. 129, 176 (1943) ("The rule requiring taxation of income from the recovery or cancellation of items previously deducted is a remedial expedient, designed to prevent the unjust enrichment of a taxpayer and to offset the benefit derived from a deduction to which, in the light of subsequent events, the taxpayer was not entitled"); Byrne, *The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments*, 56 Notre Dame Law. 215, 232 (1980) ("The tax benefit rule has been designed by the courts as a tool for correcting the distortion resulting from a taxpayer's taking a deduction which, in the light of subsequent events, exceeds his loss or cost"). See also Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the P.G. Lake Case*, 17 Tax L. Rev. 295, 411 (1962).

that when a taxpayer takes a deduction, he is constructively recouping his capital investment, so that any further amounts received with respect to the deducted item lose their nature as returns of capital and take on, instead, the characteristics of the original income that had been offset by the deduction.[17]

In *Philadelphia National Bank* v. *Rothensies*, 43 F. Supp. 923, 925 (E.D. Pa. 1942), the court characterized the rule in terms of waiver or estoppel. As it explained, a taxpayer who has claimed a deduction is presumed to have consented to the recovery of the deduction should it later turn out that the deducted amount exceeded his actual cost or loss. See also *Commissioner* v. *First State Bank*, 168 F.2d 1004 (5th Cir.), cert. denied, 335 U.S. 867 (1948), where the court held that a bank that distributed notes to its shareholders, after having previously charged off the notes as worthless, was chargeable with additional income when the shareholders later made collections on the notes. While the majority opinion rested this result on assignment of income principles (168 F.2d at 1010), the concurring opinion of Judge Sibley (speaking for himself and two of the other five judges) further indicated that the bank had assumed both "the legal and the moral duty" to restore future recoveries to income

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[17] The court in *National Bank of Commerce* appears to have adopted this theory of "transubstantiation of capital into income" (1 B. Bittker, *supra*, ¶ 5.7.1, at 5-46) in order to avoid what it perceived as the problem of imposing a tax in the absence of the realization of "income." We would suggest, however, that the constitutional implications of the tax benefit rule are not as formidable as the court believed. Nothing in the Sixteenth Amendment itself would require such a rigid adherence to an annual accounting concept as to preclude the making of adjustments in later periods under the "balancing entry" theory articulated in *South Dakota Concrete* whether or not any "income" as such has been received in the year of the adjustment. As this Court noted in *United States* v. *Skelly Oil Co.*, *supra*, 394 U.S. at 684, "the annual accounting concept does not require us to close our eyes to what happened in prior years." At all events, as the Eighth Circuit noted in *Lamont* v. *Commissioner*, *supra*, the tax is imposed not on fictional income but on the restoration to taxable income of the real gains that escaped taxation in the first instance as a result of the prior deduction.

when it claimed the deductions and that it could not free itself of that obligation simply by transferring the uncollected notes to its shareholders (168 F.2d at 1011).

The common thread linking the judicial and scholarly theories addressing the basis of the tax benefit rule is that they all recognize that the "recovery" or other event triggering the application of the tax benefit rule does not, of itself, constitute taxable income in the current year. Rather, income is recognized in the current year only because events of the current year have demonstrated the invalidity of the assumptions underlying a previously claimed deduction that served to reduce taxable income for a prior year. As Professor Bittker states in his authoritative treatise:

> While divergent, these theories share the view that the recoveries do not constitute economic gain in the ordinary sense and that their inclusion in income is an anomaly requiring explanation. The premise, evidently, is that a creditor's collection of a just debt does not increase his net worth, even if he previously concluded that the debtor would never pay, and that a homeowner would not ordinarily think that partial refund of his local property tax, following recomputation of his liability in the light of hindsight, was an income-producing event. *Thus, the taxpayers in these cases are treated as realizing income only because they deducted amounts that, it now appears, exceeded their actual loss or cost.*

1 B. Bittker, *supra*, ¶ 5.7.1, at 5-47 to 5-48 (emphasis added).

Since the basis of the tax benefit rule is the need to correct the income distortion caused by a taxpayer's having claimed a deduction for an expense or loss which, in the light of hindsight, exceeded his actual expense or loss, it follows that the rule should apply on the occurrence of any event that refutes the correctness of the factual assumptions underlying a previously claimed deduction. An actual recovery of money or property is "simply the *usual* manifestation of an 'inconsistent event,'" Byrne, *The Tax Benefit Rule as Applied to Corporate Liquida-*

tions and Contributions to Capital: Recent Developments, 56 Notre Dame Law. 215, 232 (1980) (emphasis added). It is not, however, the only type of inconsistent event that triggers the application of the rule.[18]

3. *Nash* v. *United States*, 398 U.S. 1 (1970), upon which petitioner Hillsboro Bank relies (H. Br. 16-17), is not to the contrary. There, a partnership that had previously established a bad debt reserve and had

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[18] Petitioner Hillsboro Bank complains (Br. 10-11) that the "inconsistent event" formulation of the tax benefit rule articulated in *Estate of Block* v. *Commissioner*, 39 B.T.A. 338, 341 (1939), aff'd, 111 F.2d 60 (7th Cir.), cert. denied, 311 U.S. 658 (1940)—is broader than was required by the facts of that case, which involved an actual recovery. Under that formulation, "[w]hen recovery or some other event which is inconsistent with what has been done in the past occurs, [then] adjustment must be made in reporting income for the year in which the change occurs." *Tennessee-Carolina Transportation, Inc.* v. *Commissioner*, 582 F.2d 378, 382 (6th Cir. 1978), cert. denied, 440 U.S. 909 (1979); *First Trust & Savings Bank* v. *United States*, 614 F.2d 1142, 1145 (7th Cir. 1980). Accord: *Rosen* v. *Commissioner*, 611 F.2d 942, 944 (1st Cir. 1980); *Unvert* v. *Commissioner*, 656 F.2d 483, 485 (9th Cir. 1981), cert. denied, No. 81-1467 (May 3, 1982). See also *Bonaire Development Co.* v. *Commissioner*, 76 T.C. 789, 797-801 (1981), appeal pending, No. 81-7469 (9th Cir.).

But the "inconsistent event" formulation is an authoritative synthesis of the tax benefit rule, as applied in the early cases. It encompasses the cases involving actual recoveries (such as *South Dakota Concrete* and *Estate of Block*), cases involving what might be characterized, at best, as "constructive" recoveries (such as *G.M. Standifer Construction Corp.* v. *Commissioner*, *supra*), as well as cases such as *Barnett* v. *Commissioner*, *supra*, and its progeny, in which no recovery, either actual or constructive, could be attributed to the taxpayer.

See also, *e.g.*, *Mayfair Minerals, Inc.* v. *Commissioner*, 456 F.2d 622 (5th Cir. 1972); *Bear Manufacturing Co.* v. *United States*, 430 F.2d 152 (7th Cir. 1970), cert. denied, 400 U.S. 1021 (1971); *Lime Cola Co.* v. *Commissioner*, 22 T.C. 593, 601-602 (1954); *Chicago, R.I. & P. Ry.* v. *Commissioner*, 13 B.T.A. 988, 1022-1023 (1928), aff'd, 47 F.2d 990, 992 (7th Cir.), cert. denied, 284 U.S. 618 (1931), where, as in *G.M. Standifer Construction Corp.*, the tax benefit rule was applied to require taxpayers to include in income the amount of liabilities that had been accrued and deducted but never paid.

taken the appropriate deductions for additions to that reserve, transferred all of its assets (including its accounts receivable) to a newly formed corporation in exchange for that corporation's stock, pursuant to Section 351 of the Code. The parties agreed that at the time of the transfer, the amount of the bad debt reserve was reasonable so that the value of the stock received upon the transfer was equal to the net value of the receivables. On these facts, the Court rejected the Commissioner's argument that the reserve should be restored to the partnership's income because it was no longer needed in its business. Rather, the Court held that the tax benefit rule did not require the partnership to restore the reserve to income because the partnership received no gain as a result of the transaction. As it observed, "[w]e do not, however, understand how there can be a 'recovery' of the benefit of the bad debt reserve when the receivables are transferred less the reserve. That merely perpetuates the status quo and does not tinker with it for any double benefit out of the bad debt reserve" (398 U.S. at 5; footnote omitted).

The particularized circumstances of *Nash* do not cast doubt upon the "inconsistent event" formulation of the tax benefit rule to which we subscribe. The factual premises underlying the deductions that were taken by the partnership in establishing and maintaining the reserve were in no way contradicted by the partnership's transfer of those receivables to the corporation under Section 351.[19] The transaction therefore was not an event that was inconsistent with the claim of those prior deductions. Since the partnership's basis in the receivables was identical to their fair market value at the time of the transfer and the corporation took that basis,

[19] Pursuant to Section 362(a) of the Code, the corporation was required to take the partnership's basis in the receivables (face amount less the reserve). Hence, the corporation would have had to take into income any collections in excess of its basis in the receivables, just as the partnership would have been required to do.

there was neither gain to the partnership nor the potential for any double tax benefit.[20]

Here, on the other hand, as we shall point out in greater detail, the State's refund of the taxes previously deducted by petitioner Hillsboro Bank, and the distribution to Bliss Dairy's shareholders of cattle feed that had previously been "expensed" by that corporation, are events that establish the invalidity of, and are therefore inconsistent with, the factual assumptions on the basis of which Hillsboro and Bliss previously claimed their deductions. Hillsboro Bank obtained the benefit of a deduction for a "tax" liability that was not ultimately incurred; Bliss Dairy enjoyed an "expense" deduction for materials that were not ultimately used in its business and that, thus, remained available as valuable assets for sale or distribution to shareholders. Absent the application of the tax benefit rule requiring the restoration of deduction of taxes to Hillsboro Bank's income upon the refund of the taxes to its shareholders, the Bank would obtain the anomalous result of obtaining

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[20] As Rev. Rul. 78-278, Rev. Rul. 78-279 and Rev. Rul. 78-280, 1978-2 Cum. Bull. 134, 136 and 139, point out, the decision in *Nash* would not necessarily preclude the application of the tax benefit rule with respect to bad debt reserves where a subsidiary distributes its assets to its parent pursuant to a liquidation under which the assets acquire a new basis pursuant to Section 334(b)(2) of the Code. For example, where accounts receivable had a value greater than the face value of such accounts less the bad debt reserve and where the transferee acquired the account subject to a basis equal to that greater amount, the transferor would be required, under those rulings, to restore to income the excessive additions to its bad debt reserve. In such circumstances, of course, the transferee, having acquired a new basis for the receivables, would be permitted to collect the full net value of the transferred accounts without realizing additional income, and would be entitled to claim further loss deductions in the event any lesser amounts were ultimately recovered. See also *Home Savings & Loan Association* v. *United States*, 514 F.2d 1199, 1200-1201 (9th Cir. 1975), cert. denied, 423 U.S. 1015 (1975), requiring the restoration of a previously deducted bad debt reserve to income on such a liquidation governed by Sections 332 and 334(b)(2).

a deduction for a dividend distribution to its shareholders. Moreover, since the transferee-shareholders in *Bliss Dairy* took the feed from their corporation at a "stepped-up" basis, they were able to claim further deductions with respect to that same item when they used the feed in their individually owned business. Accordingly, unlike the situation in *Nash*, the application of the tax benefit rule in these cases forecloses an improper deduction for the payment of dividends and a double tax benefit for the same item of expense. Hence, "Nash simply does not stand for the proposition, for which it is cited by taxpayer, that the tax benefit rule only applies in the case of an actual physical, as opposed to 'fictional,' recovery of a previously deducted amount." *Tennessee-Carolina Transportation, Inc.* v. *Commissioner*, 582 F.2d 378, 383 (6th Cir. 1978), cert. denied, 440 U.S. 909 (1979). See also Rev. Rul. 78-278, 1978-2 Cum. Bull. 134; Byrne, *The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments*, *supra*, at 232-233.

II

THE PERSONAL PROPERTY TAXES PREVIOUSLY DEDUCTED BY HILLSBORO BANK SHOULD BE RESTORED TO INCOME WHEN THE AMOUNTS IT PAID INTO ESCROW WERE REFUNDED TO ITS SHAREHOLDERS ON WHOSE BEHALF THEY HAD BEEN DEPOSITED

1. Ordinarily, where a corporation satisfies an obligation owing by its shareholders, the corporation is not entitled to claim the benefit of a deduction with respect to the payment. If the corporation nevertheless discharges its shareholders' obligations, the effect is that of a dividend distribution so that the shareholders themselves are charged with the receipt of dividend income to the extent their own obligations are satisfied. See, *e.g.*, *Wall* v. *United States*, 164 F.2d 462, 464 (4th Cir. 1947). Cf. *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729 (1929). As early as 1921, however, Con-

gress enacted special provisions allowing corporations to claim deductions for the unreimbursed payment of personal property taxes imposed on a shareholder's interest in the corporation. Revenue Act of 1921, ch. 136, Section 234(a)(3), 42 Stat. 254. These special provisions, allowing the corporation (rather than the shareholder) to claim a deduction for such taxes, have been carried over into successive revenue statutes and are now incorporated in Section 164(e) of the 1954 Code.

Under this Court's decision in *United States* v. *Consolidated Edison Co.*, 366 U.S. 380 (1961), however, deductions for payments of contested liabilities (such as the personal property taxes paid by Hillsboro Bank) would have been required to be deferred, in the case of accrual basis taxpayers, until such time as the liability had been finally resolved. In response to that decision, Congress enacted Section 461(f) of the Code, which allows a deduction for contested liabilities where "the taxpayer transfers money or other property to provide for the satisfaction of the asserted liability" and the deduction would otherwise be allowable. In support of this proposed change, the Senate Committee Report indicated that "allowing the deduction of items in the year paid * * * more realistically matches these deductions up with the income to which they relate than would the postponement of the deduction, perhaps for several years, until the contest is settled." S. Rep. No. 830, 88th Cong., 2d Sess. 100 (1964). The Committee also explicitly indicated, however, its understanding that the tax benefit rule would operate to offset any deduction for an expense that proved not to have been incurred. It therefore stated that "[t]o the extent that deductions are allowed under this rule and then subsequently, as a result of the contest, the items were found not to be payable, adjustment can be made for this overstatement of the deduction by the inclusion of the overstatement in income in the year in which the amount of the liability is finally determined" (*ibid.*).

Accordingly, Hillsboro Bank was unquestionably entitled, under Sections 164(e) and 461(f), to deduct

the amounts placed in escrow for payment of the contested Illinois personal property taxes in the year that payment was made. See Treas. Reg. § 1.461-2(c)(1) and (c)(2), Example (2) (26 C.F.R.). But once it was determined in the following year that the Illinois constitutional provision at issue in this Court's decision in *Lehnhausen* v. *Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973), was valid and that the personal property taxes paid on behalf of individual shareholders were not owing, a restoration to Hillsboro Bank's income of the previously deducted amount was required, despite the fortuitous fact that the refund was directed to the shareholders on whose behalf the tax had been paid rather than to the Bank itself.

The refund of the amounts previously paid on behalf of the Bank's shareholders for satisfaction of the personal property tax liability that might ultimately have been determined to be owing undermines the factual premise upon which the Bank previously deducted such amounts pursuant to Sections 164(e) and 461(f) of the Code. As we have noted (page 31, *supra*), Congress specifically intended that any "overstatement of the deduction" would be restored to income in the event that the contested liability is "finally determined." S. Rep. No. 830, *supra*, at 100. That refund in this case was paid directly to the shareholders on whose behalf the amounts were deposited in the escrow account pursuant to Ill. Ann. Stat. ch. 120, § 676.01 (Smith-Hurd Cum. Supp. 1981), rather than to the Bank alone, or to the Bank and its shareholders jointly, is not a sufficient basis for allowing the Bank to retain the benefit of its prior deduction. Regardless of who is ultimately entitled to receive the refunded amount, the determination of nonliability and the consequent tax refund (whether to the Bank or to its shareholders) are inconsistent with the allowance of a deduction to any party under Section 164. While amounts were deposited for satisfaction of an asserted liability and, as a result, properly deducted at that time, no tax liability was, in fact, ever incurred by the Bank or its

shareholders. Instead, what ultimately occurred was that the corporate funds that were originally deposited by the Bank for this purpose were diverted, via the escrow deposit, to its shareholders.

Indeed, as the court below recognized both in this case (H. Pet. App. A-8) and previously in the virtually identical situation in *First Trust* (614 F.2d at 1147),[21] the ultimate result in each case was to transform the escrow deposit into a dividend from the Bank to its shareholders. For, absent the special treatment allowed under Section 164(e), the payment of these taxes on behalf of the shareholders would have been treated as a dividend in the first instance. But the justification under those provisions for avoiding dividend treatment at that time (see Treas. Reg. § 1.164-7 (26 C.F.R.)) entirely disappeared when the taxes were determined not to be owing and the amounts previously paid on the shareholders' behalf were distributed to those same shareholders. Thus, unless the tax benefit rule applies to restore the erroneous deduction to Hillsboro Bank's income, the Bank will have obtained the benefit of a wholly improper tax deduction for what was in the end no more than a dividend distribution to its shareholders. The corrective tax benefit rule is designed to prevent such an anomaly.[22]

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[21] The refund checks in *First Trust* were made out jointly to the bank and its shareholders, while in *Hillsboro* they were issued directly to the shareholders. That, however, is a distinction without a difference since the Appellate Court of Illinois in *Lincoln National Bank* v. *Cullerton*, 18 Ill. App. 3d 953, 958-959, 310 N.E.2d 845, 848-849 (1974), ruled that, pursuant to Ill. Ann. Stat. ch. 120, § § 676.01 (Smith-Hurd Cum. Supp. 1981), the amounts deposited in the escrow account belonged to the individual shareholders, not to the banks that made the deposits. See also *Bank & Trust Co.* v. *Cullerton*, 25 Ill. App. 3d 721, 324 N.E.2d 29 (1975). Accordingly, the bank in *First Trust* was obligated, as noted by the court of appeals in *Hillsboro* (H. Pet. App. A-6), to endorse over those refund checks to its individual shareholders.

[22] Hillsboro contends (H. Br. 21) that it cannot be found to have distributed dividends unless they have been declared as such by its board of directors. It is well settled, however, that for federal tax

2. The dissenting judge below argued that application of the tax benefit rule would unjustifiably result in taxation of both the Bank and its individual shareholders upon the amounts refunded to those individuals (H. Pet. App. A-14 to A-20). It is, however, settled beyond peradventure under federal tax law that corporate income taxable to the corporation is, upon distribution as dividends, taxed again at the shareholder level without a corresponding deduction to the corporation. As the Seventh Circuit earlier stated in *First Trust* (614 F.2d at 1147):

> But, of course, the distributed refunds were corporate dividends, taxable to the stockholders when received, but, nevertheless, nondeductible expenses to the Bank under our familiar system of "double taxation" at both the corporation and shareholder level. I.R.C. §§ 316, 301. Thus, unless the deduction previously taken is reversed (by taxing the amount of the refund), the Bank will, in effect, have benefited from a deduction taken for a nondeductible distribution.

Nor is there any unfairness in this result. Hillsboro presumably knew, from the outset, that the taxes in question were being contested and would not be owing in the event the validity of Illinois constitutional provisions in issue was sustained by this Court. It was also presumably aware of the possibility that payments it had made on behalf of its shareholders would be refunded, in the event that liability were set aside, to the shareholders themselves.[23] That liability, moreover, was solely

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purposes, dividend distributions may take many forms, and need not be formally declared or even intended. See, *e.g.*, *Baumer* v. *United States*, 580 F.2d 863, 876 (5th Cir. 1978); *Honigman* v. *Commissioner*, 466 F.2d 69, 73 (6th Cir. 1972). See also *Commissioner* v. *Gordon*, 391 U.S. 83, 89-91 (1968). See generally B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 7.05, at 7-27, 7-28 (4th ed. 1979).

[23] While the provisions of Ill. Ann. Stat. ch. 120, § 676.01 (Smith-Hurd Cum. Supp. 1981), providing that "[e]ach taxpayer for whom

that of the shareholders and not that of the Bank itself. While it was customary for Illinois banks to pay such taxes on behalf of their shareholders, the statute required only that the bank retain so much of any dividends that it might distribute to shareholders as would be necessary to pay the taxes levied against their shares. Ill. Ann. Stat. ch. 120, § 558 (Smith-Hurd 1970). See, *e.g.*, *People* v. *First National Bank*, 33 Ill. 2d 457, 211 N.E.2d 713 (1965); *People* v. *Oak Park Trust & Savings Bank*, 351 Ill. 334, 184 N.E. 643 (1933); *People* v. *Toluca State Bank*, 327 Ill. 638, 159 N.E. 240 (1927).[24] Having chosen to use corporate funds to satisfy the personal obligations of the shareholders, Hillsboro can hardly complain that dividend treatment is unwarranted when the funds themselves were paid over to those same shareholders. While a deduction was proper for the year 1972 based on the circumstances existing as of the end of that year, it was clear, by the next year, that the tax liability on which that deduction was based did not exist. Restoration to income of the amount that escaped tax in 1972 was thus no less appropriate in these circumstances than would be the case if the escrow payments had been returned directly to the Bank for its own determination as to whether such amounts should then be distributed to the shareholders or reinvested on their behalf.

3. Hillsboro rests virtually its entire argument on the premise that the tax benefit rule requires the receipt by the taxpayer of an actual economic benefit in the year

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such tax payments are placed in escrow shall be eligible for automatic full repayment from the county collector if such personal property taxes are ultimately held to be invalid" was not finally approved until July 27, 1972, some 21 days after the amounts in question were paid, the bill itself had passed in the Illinois General Assembly on June 29, 1972. See 1972 Ill. Laws, Pub. Act 77-2133.

[24] If the Bank had simply withheld from dividends an amount sufficient to pay the taxes, the shareholders would presumably have been entitled to claim the deduction themselves under Section 164(a)(2). The Bank then would not have been entitled to claim a deduction under Section 164(e). See *Wisconsin Gas & Electric Co.* v. *United States*, 322 U.S. 526 (1944).

in question. But, as we have pointed out (pages 21-30, *supra*), that is not the basis of the rule. Even where there is an actual recovery, there would be no occasion for charging the taxpayer, on that ground alone, with the realization of additional gross income. Rather, what is required is the restoration to taxable income of the taxpayer's prior income that escaped tax in earlier periods solely as a result of deductions that were proper when claimed, but which were based on anticipated losses or expenses that subsequent events establish will not be incurred.[25] The fact that the liability for the Illinois personal property tax in question was not resolved until after the deduction was claimed in 1972 resulted, as the court below concluded (H. Pet. App. A-8), in a significant "windfall" to the Bank in the form of avoiding federal income tax liability on the income offset by that deduction. Had Section 461(f) not been enacted, such contested liabilities would not have been deductible in the first instance. That statute enabled the Bank to claim a deduction in 1972. At the same time, the Bank's claim of a deduction for a contested liability necessarily gave rise to the possibility that the income that thereby escaped taxation would have to be restored in the later period in which the disputed liability was finally resolved.

What is more, the application of the tax benefit rule in these circumstances is not—as Hillsboro would have it (H. Br. 19-20)—dependent upon either assignment-of-income or constructive receipt theories. The judicial de-

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[25] *Commissioner* v. *First Security Bank*, 405 U.S. 394 (1972), upon which Hillsboro relies (H. Br. 8), is not in point. There, this Court ruled that the Commissioner could not allocate income under Section 482 of the Code to certain banking subsidiaries of a holding company where such subsidiaries did not receive and were legally prohibited from receiving the income in question. The present case, however, in no way involves an allocation of income, under Section 482 or otherwise, among related parties. Rather, the Commissioner's position here is based on the fact that the Bank itself enjoyed the benefit of a deduction that is no longer justified.

velopment of the tax benefit rule shows that it arises from the need to offset the distortion resulting from the taking of a deduction of an anticipated expense or loss that is not ultimately incurred. The motives, perceptions and conduct of the taxpayer involved are irrelevant. Accordingly, Hillsboro's arguments (H. Br. 21-22) that it did not engage in collusion with the County Treasurer's office regarding the recipients of the tax refunds in no way affects application of the tax benefit rule.

Finally, even if some form of recovery is deemed to be necessary to invoke the tax benefit rule, we submit that the Bank should be deemed to have at least constructively recovered the refunded taxes. Indeed, that is precisely what the Tax Court determined in this case. It stated that "When in 1973 [Section 164(e)] was retroactively determined not to apply, and the taxes paid were refunded to these same shareholders, [the Bank] must be deemed to have received back its payments from the state and itself paid these amounts out to its shareholders" (H. Pet. App. A-39).

III

THE AMOUNTS PREVIOUSLY DEDUCTED BY BLISS DAIRY THAT ARE ATTRIBUTABLE TO CATTLE FEED UNCONSUMED IN ITS BUSINESS AND DISTRIBUTED TO ITS SHAREHOLDERS ON LIQUIDATION SHOULD BE RESTORED TO ITS TAXABLE INCOME FOR ITS YEAR OF LIQUIDATION

A. A Corporation's Distribution Of Previously Deducted Cattle Feed To Its Shareholders Refutes The Assumptions Underlying The Corporation's Claim To Deductions For The Cost Of That Feed

1. On its return for the taxable year ending June 30, 1973, respondent Bliss Dairy deducted the full cost of the $150,199 worth of cattle feed that it had purchased in that year. This deduction was based on the assumption that, even though income might be more accurately reflected through the use of inventory accounting for

such supplies, the feed would ordinarily be consumed within a relatively short time in the course of the taxpayer's operation of the business. See *Spitalny* v. *United States*, 430 F.2d 195, 197 (9th Cir. 1970); Rev. Rul. 79-229, 1979-2 Cum. Bull. 210. Cf. *United States* v. *Catto*, 384 U.S. 102 (1966). However, only $93,634 of the feed was consumed in the year for which the deduction was claimed. On the second day of the next taxable year, Bliss adopted a plan of liquidation and, within the month, distributed the remaining $56,565 worth of previously expensed feed to its shareholders. This in kind of distribution of unconsumed feed eliminated the basis for the original assumption underlying Bliss' deduction that the feed would be consumed in the ordinary course of Bliss' business. If Bliss Dairy had permitted the feed to be used for the personally-owned cattle of its shareholders there would be no question that its deduction for that feed would have to be restored to income. Accordingly, Bliss' liquidating transfer of the feed was likewise an appropriate event for applying the tax benefit rule so as to require a restoration of the amount deducted in the prior year for the distributed feed.[26]

There are, to be sure, instances in which a transfer of previously "expensed" property would not be inconsistent with the deduction and in which the restoration to income of the previously deducted amount would not be warranted. For example, where property is transferred to a successor corporation pursuant to a corporate reorganization within the scope of Section 368(a)(1) of

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[26] There is no indication in the record that any part of the $56,565 liquidation date value was due to an increase in the market price of cattle feed between the date the feed was purchased and the date of liquidation. If that were the case, however, the amount includable in Bliss' income under the tax benefit rule would, of course, be limited to the actual cost of that feed. See *Tennessee Carolina Transportation, Inc.* v. *Commissioner*, 65 T.C. 440, 448 (1975). It is the purpose of the tax benefit rule to counter-balance prior, unwarranted deductions, not to tax asset appreciation caused by market forces.

the Code or to a parent corporation on the liquidation of a subsidiary under Section 332 of the Code (other than a liquidation to which Section 334(b)(2) applies), the property remains in corporate solution and the transaction is generally treated, for federal income tax purposes, as "work[ing] a change of form rather than of substance." B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 11.40, at 11-31; ¶ 14.01, at 14-6 (4th ed. 1979). In either of these cases, the transferee corporation takes the property subject to the same basis that it had in the hands of the transferor—zero, of course, in the case of property that had already been fully "expensed" at the time of the transfer. See Sections 334(b)(1) and 362(b). See also B. Bittker & J. Eustice, *supra*, ¶ 11.44, at 11-41 and 11-42; ¶ 14.33, at 14-108 and 14-109. For example, if the unconsumed cattle feed had been transferred to a parent corporation or to a successor corporation in a qualifying reorganization, its zero basis would have carried over to the transferee and no further deduction would have been taken.[27] In these special circumstances, the transferee is deemed to have stepped into the shoes of the transferor.

A substantially different situation is presented, however, when fully "expensed" property is transferred out

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[27] The net result in these cases would be precisely the same as if the feed had been retained and used by the transferor itself in its succeeding taxable years, *viz.*, there would have been a one-year deferral of tax to the extent the cost of unused feed was used to offset otherwise taxable income for the first year. While the use of inventory accounting in the first instance would have eliminated even this temporary distortion in income, the temporary shifting of income is considered too inconsequential to mandate the use of inventories in such cases.

The transfer of property to a corporation in a transaction governed by Section 351 is similarly treated as a mere change of form, with the corporation taking the property subject to the same basis as it had in the hands of the transferor. See B. Bittker & J. Eustice, *supra*, ¶¶ 3-01 and 3.12. Cf. *Nash* v. *United States*, *supra*, 398 U.S. 1.

of corporate solution, as in the instant case, or to another corporation in a transaction that is not treated, for tax purposes, as simply working a change of form. See *Tennessee-Carolina Transportation, Inc.* v. *Commissioner, supra.* In these cases, the zero (or other) basis of the property in the hands of the transferor does not carry over to the transferee in such instances. For example, where the stock of a liquidating corporation is acquired by a corporation pursuant to a transaction qualifying under Section 334(b)(2) of the Code, the transferee is treated as a purchaser of the underlying assets and is accordingly entitled to allocate the cost of acquiring the stock among all the assets acquired (including previously "expensed" items). See *e.g., Kimbell-Diamond Milling Co.* v. *Commissioner*, 14 T.C. 74 (1950), aff'd, 187 F.2d 718 (5th Cir.), cert. denied, 342 U.S. 827 (1951); *Kansas Sand & Concrete, Inc.* v. *Commissioner*, 462 F.2d 805 (10th Cir. 1972); *In re Chrome Plate*, 614 F.2d 990 (5th Cir. 1980). B. Bittker & J. Eustice, *supra*, ¶ 11.44, at 11-42 through 11-48. Other shareholders who receive in-kind liquidating distributions ordinarily take the property at a basis equal to its fair market value on the date of distribution. Section 334(a); B. Bittker & J. Eustice, *supra*, ¶ 11.04.

Finally, where, as here, a corporation is liquidated pursuant to the elective provisions of Section 333,[28] the shareholder's basis in his stock (reduced by any money received and increased by any gain recognized on the transaction) is likewise allocated among the assets acquired in accordance with their relative fair market values. Section 334(c) of the Code; Treas. Reg. § 1.334-2 (26 C.F.R.). See generally B. Bittker & J. Eustice, *supra*, ¶ 11.22. Although the basis of distributed assets may vary depending on whether Section 334(a),

[28] Section 333 permits the shareholders to limit the amount of gain recognized on the liquidation to their pro rata shares of the corporation's earnings and profits or, if greater, the amount of money and certain securities acquired in the liquidation.

334(b)(2) or 334(c) applies, in each instance the "expensed" items do not retain the "zero" basis they had in the hands of the transferor, but acquire an appropriately "stepped-up" [29] basis in the hands of the transferees enabling them, as in *Bliss Dairy*, to claim a further deduction when the items are actually consumed in the course of their separate businesses, or to avoid the recognition of gain in the event they choose to sell the previously expensed materials to third parties.

Thus, the result in cases involving liquidations, such as *Bliss Dairy*, is not simply to shift income temporarily from one period to another, but to leave the transferor (unless the tax benefit rule is applied) with the permanent "tax benefit" of an "expense" deduction for the cost of items that were not, in fact, consumed, and never will be consumed, in its own trade or business. Moreover, shareholders will be able to claim a further deduction for the same item. As this Court has admonished, "* * * the Code should not be interpreted to allow * * * 'the practical equivalent of double deduction'; *Charles Ilfeld Co.* v. *Hernandez*, 292 U.S. 62, 68 (1934), absent a clear declaration of intent by Congress." *United States* v. *Skelly Oil Co.*, *supra*, 394 U.S. at 684. See also *Marwais Steel Co.* v. *Commissioner*, 354 F.2d 997 (9th Cir. 1965).

Indeed, the case for the application of the tax benefit rule is considerably strengthened by the fact that the facts present not simply the "practical equivalent" of a

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[29] Respondent Bliss Dairy (Br. in Opp. 2, 9) apparently takes the position that its shareholders did not take a "stepped-up" basis in the corporate assets, but took a carryover basis in those assets because their basis in the assets was equal to their basis in the stock of the corporation. But that is not a carryover basis within the parlance of the tax law. The term carryover basis connotes the same basis in the same item of property. Hence, if the shareholders took the *corporation's* zero basis in the feed, they could have a carryover basis because the corporation's basis would "carry over" to the shareholders. But where, as here, the shareholders' basis in the feed (and other assets) was computed by reference to their basis in their stock, their basis in the feed will necessarily be greater than zero. In these circumstances, they are said to have taken a "stepped-up" basis in the feed.

double deduction but an actual potential double deduction. Here, the shareholders of Bliss Dairy, who continued the dairy business in non-corporate form, took a "stepped-up" basis [30] in the cattle feed, and quite properly deducted the amount of that basis when the feed was consumed in the course of their business. In a prior year, Bliss Dairy claimed a similar deduction. In these circumstances, the corporation must restore to its own income that portion of the amount previously deducted that was attributable to the feed that was not ultimately used in its trade or business and that remained available for sale or distribution to shareholders on the winding up of the corporation's affairs.[31]

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[30] Although the exact amount of the shareholders' "stepped-up" basis in the feed is not in the record, it is clear that the shareholders took a "stepped-up" basis to at least some degree. See page 5, note 4, *supra*.

[31] Had the corporation instead chosen to sell the expensed feed and to distribute the proceeds to the shareholders, it is settled that it would have been required to restore the previously deducted amount to income even though the liquidation might have qualified under the provisions of Section 337 of the Code (providing for non-recognition of gain on the sale of property pursuant to a liquidation plan meeting the requirements of that section). See, *e.g.*, *Anders* v. *United States*, 462 F.2d 1147 (Ct. Cl.), cert. denied, 409 U.S. 1064 (1972); *Connery* v. *United States*, 460 F.2d 1130 (3d Cir. 1972); *Spitalny* v. *United States*, 430 F.2d 195 (9th Cir. 1970); *Commissioner* v. *Anders*, 414 F.2d 1283 (10th Cir.), cert. denied, 396 U.S. 958 (1969). While the corporation itself, in such a case, converts the "expensed" property into money, the distribution of such property to shareholders, with a "stepped-up" basis—enabling them either to claim a second deduction or to sell the property themselves, and thereby acquire the same amount of cash (largely or entirely tax-free) that they would have received had the corporation sold the property—is, we submit, equally inconsistent with the assumptions under which the deduction was originally claimed and with the corporation's retention of the "tax benefit" resulting from its practice of deducting the cost of such property in advance of its consumption. Since the economic positions of the parties are precisely the same in both instances, the tax benefit rule is likewise applicable here.

While this case and *Tennessee-Carolina*, *supra*, involve liquidation distributions, the same problem would be presented in an "in-

2. In holding that Bliss Dairy's tax benefit from its deduction for cattle feed for use in its business and its subsequent distribution to its shareholders of that feed did not require restoration of the deduction to the corporation's income unless there was an actual recovery by the corporation of money or additional property, the court below relied exclusively on its prior decision in *Commissioner* v. *South Lake Farms, Inc., supra.* It quoted the following statement from *South Lake Farms* (B. Pet. App. 4a): "Nowhere in the Code do we find an intent that gains to the stockholders were to be attributed to the corporation, much less that they were to be treated as ordinary income to the corporation" (324 F.2d at 839).[32]

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kind" distribution of "expensed" property in a non-liquidating context. In such a case, the shareholders would be charged with dividend income to the extent that the corporation had earnings and profits (Sections 301(a) and (c), and 316 of the Code). But absent the tax benefit rule, the corporation could retain the benefit of a tax deduction (and, hence, a reduction in earnings and profits) that becomes unjustified in light of the distribution. Thus, unless the tax benefit rule required the corporation to restore the previously deducted amount to income, a corporation could distribute "expensed" property remaining on hand at the end of each taxable year, and thereby enjoy the benefit of making annual tax-deductible dividends. Indeed, one could easily imagine a case in which the deduction for unconsumed materials distributed to shareholders would be sufficient to reduce earnings and profits to zero, thereby rendering such "dividends" non-taxable to the shareholders as well.

[32] It is in fact arguable that the discussion of the tax benefit rule in *South Lake Farms* is dicta. See 81-930 Pet. 8-9 n.6.

The Ninth Circuit itself has subsequently recognized that Section 336 of the Code is not a bar to the inclusion of an overstated prior deduction in income in the year of liquidation. In *Home Savings & Loan Association* v. *United States*, 514 F.2d 1199 (9th Cir. 1975), the stock in a savings and loan association was first purchased by another savings and loan association, which thereafter liquidated the acquired association. The court held that the liquidated association was required to include in its income certain amounts it had deducted as additions to its bad debt reserve prior to the take-over and liquidation. At the time the liquidating corporation's assets were distributed to the acquiring parent corpora-

The court below thus misunderstood why Bliss Dairy should be required to recognize income in the current taxable year. The government is not seeking to attribute to Bliss the gains of its shareholders. Rather, it is Bliss' own ordinary income—the income that escaped tax in a prior taxable year as a result of the deduction for cattle feed that would be consumed, if at all, only in subsequent periods—that the government seeks to restore to taxable income. Once subsequent events made it clear that the anticipated events on which the deduction was based—that the feed would shortly be used (and, thus, become an "expense") in the operation of the corporate business—would never occur, such a restoration to income is required under the tax benefit rule. Indeed, as the Ninth Circuit itself recognized in a case decided subsequently to *Bliss Dairy*, the recovery of a deduction is taxed under the tax benefit rule "because it previously created a tax benefit, not because of the inherent characteristic of the recovery." *Unvert* v. *Commissioner*, 656 F.2d 483, 486 (9th Cir. 1981), cert. denied, No. 81-1467 (May 2, 1982).

Here, where Bliss Dairy indisputably took a deduction that offset its ordinary income, and where that deduction was in an amount that, as subsequent events showed, exceeded its actual cost of doing business, the restoration of that deduction to income in its final taxable period was necessary to offset the deduction that proved to be excessive. It is that necessity that gave rise to the tax benefit rule, and calls for its application in this case.

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tion, it became clear that the projection of bad debt expenses inherent in the reserve account was overstated. The court viewed the liquidation and distribution as an event inconsistent with the former corporation's prior deductions for the reserves. Although the court stated in its opinion that it did not intend to impair the authority of *South Lake Farms* (514 F.2d at 1201 n.1), the holdings of *Home Savings & Loan*, on the one hand, and *South Lake Farms* and the present case, on the other, cannot fairly be reconciled. See *First Trust & Savings Bank* v. *United States*, *supra*, 614 F.2d 1146 n.5.

B. At All Events, Even If An "Actual Recovery" Is Required For The Application Of The Tax Benefit Rule, Bliss Dairy Enjoyed Such A Recovery

Even if the tax benefit rule requires an actual recovery to trigger its application, Bliss Dairy did enjoy the benefits of such a recovery in this case. As the Sixth Circuit noted in *Tennessee-Carolina Transportation, Inc.* v. *Commissioner*, *supra*, 582 F.2d at 382, where the cost of materials and supplies are "expensed," they are "in contemplation of the tax laws, completely consumed." This deduction is allowed and a zero basis assigned not because there has been an actual loss or exhaustion of value, but on the "contemplation of their actual consumption." As a result, they are treated, for tax purposes, as having become a "nonentity" (*ibid.*). Where, however, the corporation's own activities are wound up before such actual consumption takes place, the value of the property remains available to the corporation and its shareholders, to be enjoyed either by the sale of the property by the corporation or by distribution of the unconsumed property to the shareholders for their own sale or use. In either case, there is a "recovery" of the value that had been "fictionally" converted into an item of expense. Such a "fictional conversion" must, of course, be hypothesized to allow a current "expense" deduction because an expenditure for the acquisition of valuable assets "is capital in nature and not an expense, let alone an ordinary expense * * *." *Commissioner* v. *Lincoln Savings & Loan Association*, 403 U.S. 345, 354 (1971). The allowance of a current expense deduction for items that will ordinarily not be consumed within a short period is based on practical considerations. Those same practical considerations mandate that what is deemed to have been consumed in the year of acquisition should be deemed recovered, as the Sixth Circuit concluded in *Tennessee-Carolina*, when it is transferred from a corporation to another party.

Indeed, the Ninth Circuit itself recognized in *Spitalny* v. *United States*, *supra*, 430 F.2d at 198, that there has

been, in such circumstances, a "fictional conversion of * * * 'property' into a consumed item of expense" and that (*ibid.*)—"[i]f the feed and supplies are to revert to 'property' they should be reconverted. They should not at the same time be property and still retain attributes of a fictional nonentity." See also *Anders* v. *United States*, *supra*, 462 F.2d at 1149. In *Spitalny*, the liquidating corporation sold the previously expensed, but unconsumed, cattle feed and other expensed supplies there in question, and distributed the proceeds to the shareholders. Accord: *Tennessee-Carolina Transportation, Inc.* v. *Commissioner*, *supra*, 582 F.2d at 382. As an economic matter, the parties are in precisely the same position whether such expensed property is sold by the corporation or distributed "in kind" to the shareholders. If a restoration to income of the previously deducted amount is in order in the first instance (as virtually every court that has considered the matter has concluded—see page 42, note 31, *supra*), such a restoration is likewise appropriate here.

There is a second basis for attributing a "recovery" to the liquidating corporation—assuming such a "recovery" is essential. The liquidation of a corporation is itself an "exchange" of property—*i.e.*, a transfer by the shareholders of their shares to the corporation, in exchange for a distribution by the corporation of its assets. See B. Bittker & J. Eustice, *supra*, ¶ 11.01. While it is true that after the liquidation has been completed the shares received by the corporation loses its value, such stock presumably had the same value as the distributed assets themselves had at the time of the transaction. *Tennessee-Carolina Transportation, Inc.* v. *Commissioner*, *supra*, 582 F.2d at 382. Accordingly, at the time Bliss Dairy received its shares back from its shareholders in the course of the liquidation, that stock still had value reflecting, *inter alia*, the $56,565 in unconsumed cattle feed remaining on hand.[33] Thus,

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[33] Compare, *e.g.*, *Nash* v. *United States*, *supra*, 398 U.S. 1, where stock received on the transfer of the unincorporated business to a

under the facts of this case, there was a "recovery" of the value of the unconsumed cattle feed. While it is true that the recovery was transient, it was no less transient than the recovery would be on a liquidation sale, as in *Spitalny*, where the proceeds are immediately distributed to the shareholders in the course of liquidation.

Ordinarily, the receipt of stock by the corporation in exchange for the distribution of its assets on liquidation is not treated as a taxable transaction to the corporation. Section 336 provides that "no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation." See B. Bittker & J. Eustice, *supra*, ¶ 11.61. Thus, the value of appreciated property distributed in kind to the shareholders is not treated as having been realized by the corporation. See *United States* v. *Cumberland Public Service Co.*, 338 U.S. 451 (1950). But the provisions of Section 336 should not be considered as having any greater bearing on the application of the tax benefit rule in this context than the analogous provisions of Section 337(a) of the Code, providing that "no gain or loss shall be recognized to * * * [the] corporation from the sale or exchange by it of property" pursuant to a 12-month liquidation plan qualifying under that Section. As we have pointed out (page 42, note 31, *supra*), the courts have uniformly upheld the Commissioner's position in requiring the restoration of prior deductions to income where previously expensed items are sold pursuant to such Section 337 liquidations, despite the "no gain or loss" language of that statute. Those cases simply reflect the established understanding of the function of the tax benefit rule as requiring a restoration to income of a previously deducted amount, even though there would be no occasion for charging the taxpayer with additional income, absent the enjoyment of such a prior tax benefit.

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corporation reflected the actual "net" value of accounts receivable, and thus did not constitute a "recovery" of the amount properly added to bad debt reserves.

To construe Section 336 as precluding the application of the tax benefit rule to a corporation that distributes previously expensed property to its shareholders, notwithstanding its "recovery" of stock having an equivalent value, would result in a wholly unjustified disparity in the tax treatment of liquidations falling within Section 337 (where property is sold and the proceeds are distributed to the shareholders) and liquidation distributions of property governed by Section 336. Indeed, it was the purpose of Section 337 to eliminate such tax disparities based on whether property was sold by a liquidating corporation (as in *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945)) or distributed to the shareholders (as in *United States* v. *Cumberland Public Service Co.*, *supra*). See H.R. Rep. No. 1337, 83d Cong., 2d Sess. A 106 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 258-259 (1954).[34]

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[34] Despite the broad "no gain or loss" language of Section 337, the courts have required the recognition of income on the sale of corporate assets in a variety of contexts, including, as noted above, the sale of previously "expensed" items (*e.g.*, *Anders* and *Spitalny*, *supra*), the transfer of accounts receivable that had previously been written off in part through additions to a bad debt reserve (*West Seattle National Bank* v. *Commissioner*, 288 F.2d 47 (9th Cir. 1961)), and the transfer of contracts under which the right to receive partial or complete payment has already been earned (*e.g.*, *Commissioner* v. *Kuckenberg*, 309 F.2d 202 (9th Cir. 1962), cert. denied, 373 U.S. 909 (1963)); *Family Record Plan, Inc.* v. *Commissioner*, 309 F.2d 208 (9th Cir. 1962), cert. denied, 373 U.S. 910 (1963); and *Midland-Ross Corp.* v. *United States*, 485 F.2d 110 (6th Cir. 1973)). See B. Bittker & J. Eustice, *supra*, ¶ 11.65, at 11-82 through 11-85. It is well established that Section 336 would not preclude attributing income to the corporation itself on assignment of income principles where the right to receive contract payments is distributed to shareholders. See, *e.g.*, *Wood Harmon Corp.* v. *United States*, 311 F.2d 918, 921-923 (2d Cir. 1963); *Williamson* v. *United States*, 292 F.2d 524, 528-530 (Ct. Cl. 1961). Given the purpose of Section 337 to eliminate the disparity in treatment between liquidation sales and liquidation distributions, the Sixth Circuit properly concluded that Section 337 should be construed, insofar as possible, so as to achieve the same result. *Midland-Ross Corp.* v. *United States*, *supra*, 485 F.2d at 114-115, 118. See also *Estate of Munter* v. *Commissioner*, 63 T.C. 663, 671-677 (1975).

Assume, for example, that a liquidating corporation is in possession of $100,000 of previously expensed supplies. It may choose either (1) to sell such property for that amount and to distribute the proceeds, or (2) to distribute the property directly to the shareholders. Those shareholders, in turn, might then sell the property for the same amount or obtain the economically equivalent benefit of using the property in their own trade or business, claiming a "stepped-up" basis of the property (which will, as noted above, ordinarily equal or approach its fair market value) so as to generate further deductions from their own income. In either case, the economic positions of the parties are the same.

There is accordingly no justification for treating the transactions differently, particularly in light of the purpose of Section 337 to eliminate disparities in the tax treatment of such transactions. "[F]rom a tax policy standpoint it does not make sense that in applying a judicially created rule intended to avoid income distortions, results should differ depending on whether a corporation liquidates by way of Section 336 or 337." Byrne, *The Tax Benefit Rule as Applied to Corporate Liquidations and Contributions to Capital: Recent Developments*, *supra*, 56 Notre Dame Law, at 232. The courts are agreed that there is no reason why the corporation should not be required to restore the previously deducted amount to income when it sells the property and distributes the proceeds pursuant to Section 337. Yet, pursuant to the decision of the court of appeals in the instant case under Section 336, nothing is restored to income, and the tax savings resulting from the prior deduction are passed on to the shareholders despite the fact that the fully "expensed" property is distributed to them with a stepped-up basis. This is just the type of disparity that Congress intended to end when it enacted Section 337 as part of the Internal Revenue Code of 1954. If that intent is to be fully effectuated, liquidations under both Sections 336 and 337 should be treated alike. See *Midland-Ross Corp.* v. *United States*, 485 F.2d 110, 114 (6th Cir. 1973); B. Bitt-

ker & J. Eustice, *supra*, ¶ 11.65. Otherwise, the course set by the court below will "elevate form over substance by reviving technical differentiations put to rest in 1954 with the adoption of § 337." *Tennessee-Carolina Transportation, Inc.* v. *Commissioners*, *supra*, 582 F.2d at 383 (footnote omitted).[35]

CONCLUSION

The judgment of the court of appeals in No. 81-485 should be affirmed. The judgment of the court of appeals in No. 81-930 should be reversed.

Respectfully submitted.

REX E. LEE
Solicitor General

GLENN L. ARCHER, JR.
Assistant Attorney General

STUART A. SMITH
Assistant to the Solicitor General

GARY R. ALLEN
JAY W. MILLER
DAVID I. PINCUS
Attorneys

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[35] Indeed, in a Section 333 liquidation, such as here, the result is even more egregious because the shareholders' "gain" on the liquidation distribution is itself limited to their pro rata share of corporate earnings and profits which, of course, are themselves reduced by the deductions for items that were not actually consumed in the corporation's own operations.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 164. TAXES.

* * * * *

(e) *Taxes of shareholder paid by corporation.* Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder and where the shareholder does not reimburse the corporation, then—

(1) the deduction allowed by subsection (a) shall be allowed to the corporation; and

(2) no deduction shall be allowed the shareholder for such tax.

SEC. 332. COMPLETE LIQUIDATIONS OF SUBSIDIARIES.

(a) *General Rule.*—No gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation.

* * * * *

SEC. 333. ELECTION AS TO RECOGNITION OF GAIN IN CERTAIN LIQUIDATIONS.

(a) *General Rule.*—In the case of property distributed in complete liquidation of a domestic corporation (other than a collapsible corporation to which section 341(a) applies, if—

(1) the liquidation is made in pursuance of a plan of liquidation adopted on or after June 22, 1954, and

(2) the distribution is in complete cancellation or redemption of all the stock, and the transfer of all the property under the liquidation occurs within some one calendar month,

then in the case of each qualified electing shareholder (as defined in subsection (c)) gain on the

shares owned by him at the time of the adoption of the plan of liquidation shall be recognized only to the extent provided in subsections (e) and (f).

(e) *Noncorporate Shareholders.*—In the case of a qualified electing shareholder other than a corporation—

(1) there shall be recognized, and treated as a dividend, so much of the gain as is not in excess of his ratable share of the earnings and profits of the corporation accumulated after February 28, 1913, such earnings and profits to be determined as of the close of the month in which the transfer in liquidation occurred under subsection (a)(2), but without diminution by reason of distributions made during such month; but by including in the computation thereof all amounts accrued up to the date on which the transfer of all the property under the liquidation is completed; and

(2) there shall be recognized, and treated as short-term or long-term capital gain, as the case may be, so much of the remainder of the gain as is not in excess of the amount by which the value of that portion of the assets received by him which consists of money, or of stock or securities acquired by the corporation after December 31, 1953, exceeds his ratable share of such earnings and profits.

SEC. 334. BASIS OF PROPERTY RECEIVED IN LIQUIDATIONS.

* * * * *

(c) *Property Received in Liquidation Under Section 333.—If—*

(1) property was acquired by a shareholder in the liquidation of a corporation in cancellation or redemption of stock, and

(2) with respect to such acquisition—

(A) gain was realized, but

(B) as the result of an election made by the shareholder under section 333, the extent to which gain was recognized was determined under section 333,

then the basis shall be the same as the basis of such stock cancelled or redeemed in the liquidation, decreased in the amount of any money received by the shareholder, and increased in the amount of gain recognized to him.

SEC. 336. DISTRIBUTIONS OF PROPERTY IN LIQUIDATION.

General Rule.—Except as provided in section 453(d) (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation.

SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) *General Rule.*—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.164-7. *Taxes of shareholder paid by corporation.*

Banks and other corporations paying taxes assessed against their shareholders on account of their ownership of the shares of stock issued by such corporations without reimbursement from such shareholders may deduct the amount of taxes so paid. In such case no deduction shall be allowed to the shareholders for such taxes. The amount so paid should not be included in the gross income of the shareholder.

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Petitioner's Reply Brief

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No. 81-485

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, A.D., 1981

HILLSBORO NATIONAL BANK,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

HARVEY B. STEPHENS
MARK H. FERGUSON
ROBERT A. STUART
Brown, Hay & Stephens
700 First National Bank Bldg.
P.O. Box 2459
Springfield, Illinois 62705
(217) 544-8491
Attorneys for Petitioner.

SCHNEPP & BARNES PRINTERS, INC., SPRINGFIELD, ILL.

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Bliss Dairy, Inc. v. United States, 645 F. 2d 19 (9th Cir. 1981)

Universal, Inc. v. Commissioner, 109 F. 2d 616 (7th Cir. 1940)

No. 81-485

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ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
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REPLY BRIEF FOR THE PETITIONER

STATEMENT OF THE CASE

Because of certain omissions from the Respondent's Statement (Resp. Br., pp. 2-4), Petitioner is compelled to emphasize to this Court several undisputed facts which are part of the record in this case.

First, subsequent to this Court's decision in *Lehnhausen v. Lake Shore Auto Parts Co.*, 410 U.S. 356 (1973), the County Treasurer of Montgomery County, Illinois, without consultation with the Petitioner and without the Petitioner's knowledge, made a determination of the amount of personal property tax

refunds due. Second, the County Treasurer alone determined to whom the refunds were to be paid. The refunds to certain shareholders (*not* to the Petitioner) were ultimately made based upon these two decisions of the treasurer.

The personal property taxes paid by Petitioner represented taxes imposed upon *all* the Bank's shareholders. However, because the Illinois constitutional amendment upheld in *Lehnhausen* removed the tax only as to *individuals*, Bank shareholders who were not individuals remained subject to the tax. The County Treasurer thus took it upon himself to decide which of the shareholders were individuals and which were not.

The result of the treasurer's decision was a refund to only 132 of the Bank's 149 shareholders. The Bank was given no opportunity to challenge the treasurer's determination that the 17 who did not receive checks were not individuals. In the end, if the Respondent's contention herein is upheld, i.e., if the refunds are characterized as dividends to Bank shareholders, the Bank will be deemed to have indirectly distributed a dividend that is disproportionate as to its shareholders. Those shareholders who might have challenged their characterization by the treasurer as non-individuals were left with no remedy and no right to receive "dividends" from their corporation. These facts demonstrate the fallacy of the Respondent's characterization of the refunds as a dividend from the Bank to its shareholders.

The Respondent also misstates the facts in the text of his argument (Resp. Br., pp. 30-32). In his attempt to fit this case under Section 461(f) of the Code regarding contested liabilities, Respondent inaccurately states that Petitioner paid the amount into escrow "for payment of the contested Illinois personal property taxes" in 1972. This is simply incorrect. The Petitioner paid these taxes, as it had paid others in previous years, to the County Treasurer. It did not contest them; it did not formally protest their validity or that they were due. It did

not pay them into escrow. As far as the Bank was concerned, the taxes were proper and were paid. The escrow was established by the County Treasurer under the provisions of a special Act of the Illinois General Assembly effective *after* Petitioner had paid the taxes. It was established not by the Bank or with the cooperation or consent of the Bank, but by the State of Illinois.

SUMMARY OF ARGUMENT

The Petitioner, HILLSBORO NATIONAL BANK, denies that the tax benefit rule applies even though the taxpayer receives *no* recovery of an economic benefit.

The judicial precedents do not support the novel theory that the tax benefit rule applies whether or not a taxpayer recovers his expenditure or its economic equivalent.

This Court should not ignore the legislative intent underlying Section 111 of the Code which requires a "recovery" in order for the tax benefit rule to be invoked.

Petitioner's payment of personal property taxes for shareholders was voluntary and uncontested, and therefore, Section 461(f) is not applicable.

ARGUMENT

A. Respondent's statement of the tax benefit rule is not supported by judicial precedent, legislation or logic.

The Respondent has developed his argument from his description of the purpose of the tax benefit rule: "to assure that a taxpayer's income over a period encompassing several taxable years is accurately reflected where subsequent events establish that no loss or expenses will actually be incurred." (Resp. Br., p. 9). This reference to "loss or expenses not actually incurred" is repeated several times as if it accurately reflects the facts in this case. For example, at page 9 Respondent states that taxpayer should be treated as realizing income only because it "deducted amounts that prove to have exceeded (its) actual loss or cost." At page 14, Respondent speaks of the "amount of income actually enjoyed or the liabilities or losses ultimately incurred."

The defect in Respondent's argument is that, even after the refund of personal property taxes to Petitioner's shareholders, the Petitioner had still incurred an expense as a result of its tax payments. To this day, the taxes paid by the Petitioner have not been reimbursed; its expense was legitimate and real. Faced with this set of facts, Respondent inexplicably shifts his emphasis in this Court to the novel theory that "the factual premise" upon which the payments were made has been eliminated. But no manner of shifting of theories can justify the imposition of tax on Petitioner where it has paid a deductible expense and has not recovered it.

The Petitioner does not argue with the concept embodied in the tax benefit rule, nor with the reasons it was first enunciated by the courts. Its argument is with the Respondent's recent attempts in this and other cases to stretch the rule to cover a variety of situations to which it should not be applied. The Respondent's brief does nothing to justify the government's

zeal; to the contrary, it presents an argument, through a misreading of the relevant case law and statutes, that demonstrates it is overreaching in this case, in *First Trust & Savings Bank v. United States*, 614 F. 2d 1142 (7th Cir. 1980), in *Bliss Dairy, Inc. v. United States*, 645 F. 2d 19 (9th Cir. 1981), in *Tennessee-Carolina Transportation, Inc. v. Commissioner*, 582 F. 2d 378 (6th Cir. 1978) and in other pending cases, such as *Ameron, Inc. v. United States of America* now pending in the United States Court of Appeals for the Ninth Circuit.

The novelty of the Respondent's position in these four recent cases and the pending cases becomes readily apparent upon review of tax-benefit cases spanning the past 40 years. Regardless of the Government's attempt to transform *dicta* in those cases into judicial precedent, in not one of them has the Board of Tax Appeals, the Tax Court or a federal court applied the rule where a taxpayer has not received some recovery, or the economic equivalent of recovery, of an earlier deductible amount.

So it is that the Respondent must break new ground where the courts and Congress have refused to do so. In point of fact, the Respondent here attempts to go beyond its own tax-benefit regulations to vitiate the requirement that a recovery occur before the tax benefit rule is invoked.

1. *Judicial Precedent.*

Every case cited by the Respondent, despite his assertions to the contrary, stands upon facts that show the particular taxpayer involved enjoyed a recovery or its economic equivalent. Each case in which the tax benefit theory has been upheld, prior to *Tennessee-Carolina Transportation, Inc. v. Commissioner*, 582 F. 2d 378 (6th Cir. 1978), falls into one or more of the following categories:

> (1) Taxpayer disburses funds and for the taxable year of the disbursement properly takes a deduction therefor. In some later year, funds are actually received by the

taxpayer, which funds represent a refund to or recovery by the taxpayer of the amounts disbursed in the prior year.

(2) Taxpayer takes a deduction for a loss determined during the taxable year, such as a debt believed to be worthless, but in a later year collects the debt or otherwise receives actual compensation for the loss.

(3) Taxpayer accrues an expense or liability on its books and properly takes a deduction therefor. In a later year the expense or liability is reduced or cancelled. Although taxpayer in this case receives or recovers nothing tangible, such as cash or property, its net worth is increased and it has therefore received the economic equivalent of an actual recovery.

Admittedly, the facts of this case would fit within category (1), and the tax benefit rule could have been properly applied, *IF* the Petitioner had received the property tax refunds from the treasurer. But recognizing that this case does not fit category (1) or either of the other two, the Respondent distorts the reasoning of courts faced with category (2) or (3) cases by extracting statements out of context and attempting to apply them to the facts of this case. In so doing, the Respondent would emaciate and misapply the tax benefit rule to the point that its justification and rationale would be lost. The result would be an uncertain doctrine that allows the government to impose unfair and harsh tax results.

Although in its lower-court arguments the Respondent alluded to *Estate of Block v. Commissioner*, 39 B.T.A. 338 (1939), *aff'd sub nom., Union Trust Co. v. Commissioner*, 111 F. 2d 60 (7th Cir. 1940), *cert. denied*, 311 U.S. 658 (1940) as the earliest enunciation of the "inconsistent event" theory upon which it relies, in its Brief in this Court it has shifted its emphasis to *Barnett v. Commissioner*, 39 B.T.A. 864 (1939). Perhaps this is the result of the Respondent's newly-found belief that the "inconsistent event" theory, which it earlier espoused as an alternative branch of the tax benefit rule, now "lies at the heart" of the rule (Resp. Br., p. 20). As we shall point out, the *dicta*

from which the phrase "inconsistent event" has been culled represents nothing more than attempts by lower courts to describe situations in categories (2) and (3), which by definition do not fit the straightforward application of the rule where cash or other property is actually disbursed in one year and recovered in a later year.

Petitioner has no quarrel with Respondent's introductory statements (Resp. Br., pp. 13-16) preliminary to its argument regarding the tax benefit rule. The Petitioner recognizes that administrative requirements make the closing of taxable years necessary, even when items of income or expense may not be finally determinable for several years. Nor does Petitioner have any particular quarrel with Respondent's citation of *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931) as authority for the general principles underlying the tax benefit rule.

An examination of the specifics of the early cases, which produced the general statements upon which Respondent relies, will establish that the facts from which the rule evolved were quite different from those in this case.

Alice Phelan Sullivan Corp. v. United States, 381 F. 2d 399 (Ct. Cl. 1967), cited at pages 17 and 21 of Respondent's Brief, is a straightforward category (1) case: property was conveyed to a charity and a deduction was taken in 1939 and 1940, and the property was reconveyed in 1957. The tax benefit rule was properly applied to require inclusion in income in 1957 because the taxpayer recovered the property.

South Dakota Concrete Products Co. v. Commissioner, 26 B.T.A. 1429 (1932), is cited at pages 21 through 23 of Respondent's Brief. The taxpayer had taken a deduction for an embezzlement loss, but in a later year recovered the amounts embezzled. This is a category (2) case and the tax benefit rule was properly applied by the Board of Tax Appeals.

Barnett v. Commissioner, 39 B.T.A. 864 (1939), viewed

properly, is a case that could have been decided on the basis of applicable non-tax-benefit regulations. However, even analyzing it as a case requiring application of the tax benefit rule, as the Board of Tax appeals did in *dicta*, it falls in category (3) and the rule can be correctly applied. The taxpayer had taken a depletion deduction against the cash received on a lease of mineral property to an oil company. When the lease was cancelled, in a later year but prior to any extraction of minerals, the taxpayer was required by the Board to restore the deduction to income in that year. Depletion is, in effect, the accrual of a cost to be incurred through the mineral extraction process in later years. The cancellation of the lease prevented taxpayer from actually incurring the cost, and her net worth was increased as a result. The tax benefit rule could therefore have been properly applied.

Every other tax-benefit case fits squarely within one of the three above-described categories. See, e.g., *Estate of Block v. Commissioner*, 39 B.T.A. 338 (1939), *aff'd sub nom. Union Trust Co. v. Commissioner*, 111 F. 2d 60 (7th Cir. 1940) (Category (1) — federal estate tax payments deducted when paid, included in income in year of refund); *Rosen v. Commissioner*, 611 F. 2d 942 (1st Cir. 1980) (Category (1) — charitable deduction in year property donated, income in year property was returned); *Universal, Inc. v. Commissioner*, 109 F. 2d 616 (7th Cir. 1940) (Category (1) — federal excise taxes deducted in year paid, included in income in year of refund); *Nash v. Commissioner*, 88 F. 2d 477 (7th Cir. 1937) (Category (1) —state income tax deducted in year paid, included in income in year of refund); *G.M. Standifer Construction Corp. v. Commissioner*, 30 B.T.A. 184 (1934) (Category (3) — accrued wages deducted in year of accrual, included in income upon liquidation without payment); *Putnam National Bank v. Commissioner*, 50 F. 2d 158 (5th Cir. 1931) (Category (2) — deduction for bad debt in year determined worthless, included in income for year debt was collected).

Upon review of the foregoing cases, it is evident that the "inconsistent event" referred to by several courts (see, e.g., *Estate of Block, supra,* and *Barnett, supra*) is, in context, a reference to facts placing a case in categories (2) or (3) as herein described. Any event, other than an actual receipt by the taxpayer of the funds or property earlier disbursed, could be an "inconsistent event", but the rule never applies unless the taxpayer has received an economic equivalent of actual receipt.

While Respondent simplifies Petitioner's argument by stating it is based entirely "on the premise that the tax benefit rule requires the receipt by the taxpayer of an actual economic benefit", Respondent cites *not one case* in which application of the rule has been upheld on facts disclosing that no actual economic benefit was received. As the dissenting opinion in *Tennessee-Carolina, supra,* stated:

> "(T)he salient feature of every case cited by (the government), in which the rule was applied, is the presence of an actual economic recovery by the taxpayer, either (1) by way of receipt of funds (citations omitted); or (2) by way of discharge of an accrued liability resulting in an increase in the taxpayer's net worth (citations omitted." 582 F. 2d at 384.

The Seventh Circuit was incorrect in its application of the tax benefit rule in this case and in *First Trust & Savings Bank v. United States,* upon which the Court relied. While there is a single factual difference between this case and *First Trust,* in neither case did the taxpayer ultimately recover the funds or their economic equivalent. For the same reason, it is Petitioner's contention that the Sixth Circuit incorrectly decided *Tennessee-Carolina, supra.* However, there remains one facet of this case that would justify reversal of the Seventh Circuit without disturbing *Tennessee-Carolina* or *First Trust:* in both of those cases, the majorities actually found some "fictional" recovery of an economic benefit. The Seventh Circuit did not — and could not — find any recovery, fictional or otherwise, in this case.

2. *Legislation-Section 111 of the Code and Regulations Thereunder.*

It is widely acknowledged that the government's early attempts to extend the tax benefit rule to require inclusion of recoveries in income even if deductions had not produced an earlier tax benefit prompted enactment of Section 22(b) (12) of the Internal Revenue Code of 1939. Carried into the 1954 Code as Section 111, the statute provides for exclusion of recovered amounts to the extent their earlier deduction did not produce a tax benefit.

The Respondent would have this Court ignore Section 111 and the regulations thereunder in its attempt to impose a tax on this Petitioner. But the words of the statute and regulations should not be ignored, as they reflect Congress' (and, apparently, a former Commissioner's) understanding that the rule requires the existence of some economic recovery. Section 111 provides in pertinent part:

> "(a) *General Rule* — Gross income does not include income attributable to *the revovery* during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount." (Emphasis supplied.)

The Commissioner's regulations provide:

> "(2) Definition of 'recovery.' Recoveries result from *the receipt of amounts in respect of* the previously deducted or credited Section 111 items, . . ." (Emphasis supplied). Treas. Reg., Sec. 1.111-1(a)(2).

Had Congress or the Treasury accepted the so-called "inconsistent event" theory now urged by the Respondent, they certainly would have incorporated it in the statute or the regulations. When the statute was enacted in 1942, and the Regulations promulgated thereafter, the Board of Tax Appeals had already released its decisions containing the "inconsistent event" language in *Estate of Block* and *Barnett*, upon both of which the Respondent now relies. Since the undeniable intent

of Congress and the Treasury is that there must be economic recovery for the tax benefit rule to apply, inferentially, they rejected the "inconsistent event" theory.

3. *Absurd and Unfair Results that the Respondent's Position Would Foster.*

The best way to demonstrate the absurdity of the theory urged by the Respondent herein is to describe certain hypothetical examples that could result in application of the tax benefit rule if the Respondent succeeds here:

Example 1: In 1982, Mr. Smith pays $10,000 in medical expenses for his father, who is Mr. Smith's dependent. The $10,000 is fully deductible by Mr. Smith on his 1982 tax returns. The following year, after the father has made a claim, Medicare pays the father $7,500 in benefits for the medical expenses incurred in 1982, which the father retains and consumes. On the basis of his argument herein, Respondent would say the Medicare payments "establish the invalidity of the factual premise on which the prior year's deduction was claimed." (Resp. Br., pp. 17-18.) Respondent would require Mr. Smith to include the $7,500 in his 1983 income, even though he is in the same economic position he was in at the end of 1982. He has received no economic recovery of the expenditures.

Example 2: Mr. Jones moves to Illinois in 1970, buys a home and pays real estate taxes for the years 1970 through 1975, properly claiming deductions each year for those taxes. In 1976, a group of Illinois residents files suit claiming the real estate tax, enacted in 1969, is unconstitutional, and the Illinois Supreme Court agrees. However, the court's decision is prospective only; that is, the tax statute is ruled unenforceable only for tax years after 1976. Here, the Respondent, if his position in this case is upheld, could require Mr. Jones to include in his 1976 income all the real estate taxes he paid and deducted in 1970-1975, because the premise on which he paid those taxes —the belief that the tax statute was constitutional — has been found to be invalid.

The taxpayers in these two examples have one thing in common with the Petitioner in this case: each took income tax deductions which were unquestionably proper in the year they were taken, only to have later events outside of their control establish factual or legal circumstances which, if known in the year of the payments, would have prevented the deduction. None of the taxpayers has recovered the economic cost he or it incurred. Each is in the same financial position he or it would have been in had the later circumstances not occurred. Yet the Respondent would require each to pay taxes on what amounts to non-existent income.

The state tax credit example presented by Respondent (Resp. Br. pp. 18-19) is nothing more than a simple application of the tax benefit rule to a category (1) case described herein. Mistakenly believing that this Petitioner would require actual physical receipt of a tax refund to invoke the rule, the Respondent hypothesizes that, instead of a refund, his taxpayer receives a state income tax credit. Respondent misses the point urged by Petitioner. When a refund is determined to be due, the taxpayer receives an economic benefit, whether by cash refund or by credit to the next year's tax liability. Either way, taxpayer A would have enjoyed an economic benefit, which is not true of this Petitioner or the hypothetical taxpayers described in Examples 1 and 2.

B. Respondent's argument based upon a characterization of the Petitioner's payments as contested liabilities is without support in the record.

As the record in this case demonstrates, Petitioner voluntarily paid the taxes when due to the County Treasurer. The Petitioner did not contest its liability for the taxes nor did any shareholders of the Petitioner contest their liability for the taxes. Respondent has conceded that Section 164(e) allowed the deduction of the taxes when they were paid in 1972. Sometime after the voluntary payment of the taxes by the Petitioner, the

County Treasurer, pursuant to a special Act of the Illinois General Assembly effective July 27, 1972, placed the funds in escrow. Consequently, it was not the Petitioner who deposited the taxes in escrow.

Therefore, Respondent's argument to this Court based upon the provisions of 461(f) of the Code is completely inappropriate. Section 461(f) applies to contested liabilities. At the time the Petitioner paid the taxes voluntarily, it did not contest the tax or pay the same under protest. The Respondent's argument based upon this irrelevant Code provision should be ignored.

CONCLUSION

The fundamental basis for the judicially created tax benefit rule is an expenditure in one year and a recovery of that expenditure in a subsequent year. This Court should not support the Respondent's characterization of the tax benefit rule as being concerned only with the expenditure and not with the recovery. Even if the expenditure is later determined to be invalid, the adjustment should not be made in the subsequent year without regard to whether the expenditure or credit is recovered by the taxpayer. Therefore, Petitioner Hillsboro National Bank urges this Court to reverse the decision of the Court of Appeals for the Seventh Circuit.

Respectfully submitted,

HARVEY B. STEPHENS
MARK H. FERGUSON
ROBERT A. STUART
Brown, Hay & Stephens
700 First National Bank Bldg.
P.O. Box 2459
Springfield, Illinois 62705
(217) 544-8491
Attorneys for Petitioner.

Docket Sheet

NO. 81-485-CFX	TITLE Hillsboro National Bank, Petitioner v. Commissioner of Internal Revenue

DOCKETED	COURT
Sept. 5, 1981	United States Court of Appeals for the Seventh Circuit

DATE	PROCEEDINGS AND ORDERS
	Counsel for Petitioner: Robert A. Stuart, Harvey B. Stephens
	Counsel for Respondent: Solicitor General
Sept. 5, 1981	Petition for writ of certiorari filed. (Record filed).
Oct. 5, 1981	Order extending time to file a response to the petition until Nov. 8, 1981.
Nov. 17, 1981	Memorandum for the respondent in support of petition filed.
Nov. 18, 1981	DISTRIBUTED. 12-4. (Stricken)
Dec. 22, 1981	REDISTRIBUTED. 1-15.
Jan. 18, 1982	Petition GRANTED. The case is consolidated with 81-930 and a total of one hour is allotted for oral argument.

Feb. 5, 1982	Motion of parties to dispense with printing the joint appendix filed.
Feb. 10, 1982	DISTRIBUTED. 2-26. (Above motion)
Feb. 11, 1982	March 4, 1982 - Petitioner Hillsboro National Bank shall file its opening brief.
	April 3, 1982 - The Government will file a single brief, responding to petitioner Hillsboro National Bank's brief and as petitioner in No. 81-930.
	May 3, 1982 - Respondent Bliss Dairy, Inc. will file its answering brief.
Mar. 1, 1982	The motion of the Solicitor General to dispense with printing the joint appendix is GRANTED.
March 5, 1982	Brief for the petitioner filed.
Apr. 2, 1982	Order extending time to file the Government's brief on the merits until May 3, 1982.
Apr. 30, 1982	Order further extending time to file the Government's brief on the merits until May 17, 1982.
May 18, 1982	Brief for respondent filed. (Petitioner in 81-930).
May 24, 1982	Motion of Bliss Dairy, Inc. for divided argument filed.
June 7, 1982	The motion of Bliss Dairy, Inc. for divided argument is GRANTED.
June 14, 1982	Order extending time to file a brief on the merits on behalf of Bliss Dairy, Inc. until July 16, 1982.
September 3, 1982	CIRCULATED.
Oct. 22, 1982	Reply brief for the petitioner filed. (D).
Nov. 1, 1982	ARGUED.